NATIONAL PERFORMANCE REVIEW: CAPITAL BUDGETING FOR INVESTMENT

Y 4.G 74/7:B 85/19

National Performance Review: Capita...

HEARING

BEFORE THE

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

NOVEMBER 9, 1993

Printed for the use of the Committee on Government Operations

SUPERINTENDENT OF DOCUMENTS
DEPOSITORY
OCT 26 1994
BOSTON PUBLIC LIBRARY
GOVERNMENT DOCUMENTS DEPARTMENT

U.S. GOVERNMENT PRINTING OFFICE

80-712 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-045818-8

NATIONAL PERFORMANCE REVIEW: CAPITAL BUDGETING FOR INVESTMENT

Y 4.G 74/7:B 85/19

National Performance Review: Capita...

HEARING

BEFORE THE

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

OF THE

COMMITTEE ON GOVERNMENT OPERATIONS HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

NOVEMBER 9, 1993

Printed for the use of the Committee on Government Operations

SUPERINTENDENT OF DOCUMENTS
DEPOSITORY
OCT 26 1994
BOSTON PUBLIC LIBRARY
GOVERNMENT DOCUMENTS DEPARTMENT

U.S. GOVERNMENT PRINTING OFFICE

80-712 CC WASHINGTON : 1994

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-045818-8

COMMITTEE ON GOVERNMENT OPERATIONS

JOHN CONYERS, JR., Michigan, *Chairman*

CARDISS COLLINS, Illinois
GLENN ENGLISH, Oklahoma
HENRY A. WAXMAN, California
MIKE SYNAR, Oklahoma
STEPHEN L. NEAL, North Carolina
TOM LANTOS, California
MAJOR R. OWENS, New York
EDOLPHUS TOWNS, New York
JOHN M. SPRATT, JR., South Carolina
GARY A. CONDIT, California
COLLIN C. PETERSON, Minnesota
KAREN L. THURMAN, Florida
BOBBY L. RUSH, Illinois
CAROLYN B. MALONEY, New York
THOMAS M. BARRETT, Wisconsin
DONALD M. PAYNE, New Jersey
FLOYD H. FLAKE, New York
JAMES A. HAYES, Louisiana
CRAIG A. WASHINGTON, Texas
BARBARA-ROSE COLLINS, Michigan
CORRINE BROWN, Florida
MARJORIE MARGOLIES-MEZVINSKY, Pennsylvania
LYNN C. WOOLSEY, California
GENE GREEN, Texas
BART STUPAK, Michigan

WILLIAM F. CLINGER, JR., Pennsylvania
AL McCANDLESS, California
J. DENNIS HASTERT, Illinois
JON L. KYL, Arizona
CHRISTOPHER SHAYS, Connecticut
STEVEN SCHIFF, New Mexico
C. CHRISTOPHER COX, California
CRAIG THOMAS, Wyoming
ILEANA ROS-LEHTINEN, Florida
DICK ZIMMER, New Jersey
WILLIAM H. ZELIFF, JR., New Hampshire
JOHN M. McHUGH, New York
STEPHEN HORN, California
DEBORAH PRYCE, Ohio
JOHN L. MICA, Florida
ROB PORTMAN, Ohio

BERNARD SANDERS, Vermont
(Independent)

JULIAN EPSTEIN, *Staff Director*
KEVIN H. CRONIN, *Associate Counsel*
MECHITA O. CRAWFORD, *Staff Assistant*
MATTHEW R. FLETCHER, *Minority Staff Director*
KEVIN M. SABO, *Minority Counsel*

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE

JOHN CONYERS, JR., Michigan, *Chairman*

CARDISS COLLINS, Illinois
GLENN ENGLISH, Oklahoma
STEPHEN L. NEAL, North Carolina
CAROLYN B. MALONEY, New York
TOM LANTOS, California
CORRINE BROWN, Florida

AL McCANDLESS, California
WILLIAM F. CLINGER, JR., Pennsylvania
JON L. KYL, Arizona
DICK ZIMMER, New Jersey

JAMES C. TURNER, *Staff Director*

LIBRARY

CONTENTS

	Page
Hearing held on November 9, 1993	1
Statement of:	
Aschauer, David A., professor of economics, Bates College	44
Chambers, Letitia, president, Chambers Associates, Inc	55
Eisner, Robert, professor of economics, Northwestern University	12
Jorgenson, Dale W., professor of economics, Kennedy School of Government, Harvard University	26
Posner, Paul L., Director, Budget Studies, General Accounting Office	153
Synar, Hon. Mike, a Representative in Congress from the State of Oklahoma, and acting chairman, Legislation and National Security Subcommittee: Opening statement	1
Letters, statements, etc., submitted for the record by:	
Aschauer, David A., professor of economics, Bates College: Prepared statement	48
Chambers, Letitia, president, Chambers Associates, Inc.:	
Paper entitled, "Restructuring the Federal Budget"	57
Prepared statement	111
Clinger, Hon. William F., Jr., a Representative in Congress from the State of Pennsylvania: Prepared statement	10
Conyers, Hon. John, Jr., a Representative in Congress from the State of Michigan, and chairman, Legislation and National Security Subcommittee: Opening statement	3
Eisner, Robert, professor of economics, Northwestern University: Prepared statement	15
Jorgenson, Dale W., professor of economics, Kennedy School of Government, Harvard University: Prepared statement	32
McCandless, Hon. Al, a Representative in Congress from the State of California: Prepared statement	9
Posner, Paul L., Director, Budget Studies, General Accounting Office: Prepared statement	158
Synar, Hon. Mike, a Representative in Congress from the State of Oklahoma: Prepared statement	6

APPENDIX

Additional material submitted for the record	183

NATIONAL PERFORMANCE REVIEW: CAPITAL BUDGETING FOR INVESTMENT

TUESDAY, NOVEMBER 9, 1993

HOUSE OF REPRESENTATIVES,
LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE
OF THE COMMITTEE ON GOVERNMENT OPERATIONS,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:30 a.m., in room 2154, Rayburn House Office Building, Hon. John Conyers, Jr. (chairman of the subcommittee) presiding.

Present: Representative John Conyers, Jr.

Also present: Representatives Mike Synar and Collin C. Peterson.

Subcommittee staff present: James C. Turner, staff director.

Full committee staff present: Julian Epstein, staff director; Kevin H. Cronin, associate counsel; Mechita O. Crawford, staff assistant; and Kevin M. Sabo, minority counsel.

OPENING STATEMENT OF ACTING CHAIRMAN SYNAR

Mr. SYNAR. The subcommittee will come to order.

On behalf of Mr. Conyers, good morning. The Vice President's National Performance Review recommends several budget process reforms, including the adoption of a capital budget for fixed Federal assets such as buildings, computer systems, and telecommunication equipment. The Legislation and National Security Subcommittee has convened this morning to, once again, address the question of budget process reform and to receive testimony on the subject of capital budgeting.

Today, the United States needs to proceed along two simultaneous and conflicting paths. While we need to bring our Federal budget deficit under greater control, we must pursue a strategy for economic growth by making wise investments in the Nation, targeting our infrastructure, and our scientific capability. Our most important capital investment are our people.

Federal investment, 3.5 percent of the gross national product in 1980, represents about 2 percent of the GNP today. Increasing our productive Federal investments will strengthen our Nation, improve our ability to compete in the international marketplace, and provide opportunity for more Americans.

Our ability to fund needed national investment is closely linked to the availability of discretionary spending. Yet the category of discretionary spending is precisely the area of spending most constrained by our deficit reduction efforts. Under current law, annual spending for discretionary programs will decline in real value by

$68 billion, or 12.5 percent, over the next 5 years, driving the share of discretionary spending down to just 3.5 percent of GDP by 1998.

Many contend the unified budget, representing both current consumption and capital expenditures, fails to recognize the very different nature of these spending programs. A new budget approach, capable of distinguishing between spending for current consumption and the promotion of economic growth activities could convey the conflicting obligations more accurately and completely.

We are pleased to have with us today some of America's leading economists, with extensive academic records on the subject of investments and productivity. Additionally, we have several knowledgeable budget analysts who have developed models for a capital budget for our review today. We look forward to their testimony.

I will open the record up for any other opening statements, including our ranking minority, Al McCandless, and Bill Clinger, the ranking minority member of the full committee.

[The opening statements of Mr. Conyers, Mr. Synar, Mr. McCandless, and Mr. Clinger follow:]

OPENING STATEMENT OF JOHN CONYERS, JR., CHAIRMAN

LEGISLATION AND NATIONAL SECURITY SUBCOMMITTEE, COMMITTEE ON GOVERNMENT OPERATIONS

OVERSIGHT HEARING: CAPITAL BUDGETING FOR INVESTMENT NOVEMBER 9, 1993

Good Morning. The Vice President's National Performance Review recommends several budget process reforms, including the adoption of a capital budget for fixed Federal assets such as buildings, computer systems and telecommunication equipment. The Legislation and National Security Subcommittee has convened this morning to, once again, address the question of budget process reform and receive testimony on the subject of capital budgeting.

Today, the United States needs to proceed along two simultaneous and conflicting paths. While we need to bring our Federal budget deficit under greater control, our nation must pursue a strategy for economic growth by making wise investments in the nation, targeting our infrastructure, our scientific capability and our most important capital investment, our people.

Federal investment, 3.5% of Gross National Product in 1980, represents just 2% of GNP today. Increasing our productive Federal investments will strengthen our nation, improve our ability to compete in the international marketplace and provide opportunity for more Americans.

Our ability to fund needed national investment is closely linked to the availability of discretionary spending. Yet the category of discretionary spending is precisely the area of spending most constrained by our deficit reduction efforts. Under current law, annual spending for discretionary programs will decline in real value by $68 billion, 12.5%, over the next five years, driving the share of discretionary spending to just 3.5% of GDP by 1998.

Many contend the unified budget, representing both current consumption and capital expenditures, fails to recognize the very different nature of these Federal spending programs. A new budget approach, capable of distinguishing between spending for current consumption and the promotion of economic growth activities could convey the conflicting obligations more accurately and completely.

We are pleased to have with us today some of America's leading economists, with extensive academic records on the subject of investments and productivity. Additionally, we have several knowledgeable and experienced budget analysts who have developed models for capital budget for our review today. We look forward to their testimony.

I would like to now recognize Representative Al McCandless, ranking Minority on the Subcommittee, and Bill Clinger, ranking Minority on the full Committee, for any comments they may wish to make.

STATEMENT OF THE HON. MIKE SYNAR (D-OKLA)
Chairman, Subcommittee on Environment,
Energy and Natural Resources

Before the Government Operations Subcommittee on
Legislation and National Security
Regarding Budget-Related Reforms
November 9, 1993

Mr. Chairman, members of the Subcommittee, I appreciate the opportunity to appear today as you review Vice President Gore's proposal for "capital budgeting for investment". Let me say at the outset that I have no strong view at this time on the benefits or drawbacks of capital budgeting, and look forward to seeing this Subcommittee's recommendation on that proposal.

Instead, as this Subcommittee considers budget-related reforms, I am here to urge that you act favorably on H.R. 742, the so-called "FIRE SALE Disclosure" bill which I introduced earlier this year. As I noted during the full Committee's recent hearing on various NPR recommendations, Leon Panetta was the primary cosponsor of this proposal when I introduced it in the last Congress. I hope we can count on his continuing support for it now that he is sitting at the other end of Pennyslvania Avenue trying to help us balance our budget. The proposal makes eminent good sense and, in my view, should be included in any package of budget-related reforms adopted by the Congress.

Mr. Chairman, each year the federal government and the taxpayers lose billions of dollars selling, leasing, renting and exchanging taxpayer-owned assets. In thousands of transactions a year, the federal government fails to obtain the fair market value for these taxpayer-owned assets, because the pricing decisions are either shielded from Congressional and public scrutiny, or are masked by questionable accounting practices. As a result, the deficit is growing in part because government agencies refuse to operate as "prudent sellers" of the public's resources.

The Subcommittee on Environment, Energy and Natural Resources, which I have the honor to chair, has investigated many such transactions and natural resource subsidy programs over the past decade. Many others have as well: the General Accounting Office, the Congressional Budget Office, Inspectors General, and numerous private groups have detailed monumental sums of lost revenues attributed to "fire sale pricing" for disposal or use of various federal assets.

Billions of dollars have been lost over the past few years to pricing practices such as below-cost timber sales, no-royalty hardrock mineral claims, questionable land exchanges, no-rent land leases and transfers, undercollection of oil and gas royalties, subsidized grazing on public lands, below-market value concession contracts at recreation areas, and below-cost uranium enrichment services. Yet nowhere in the President's 1,300-page budget submission

can Members of Congress or the public find a detailed listing of these subsidies or the cost to the Treasury of each program or category of transactions that actually lose money.

I want to be very clear about one point: there are sound and justifiable reasons for many federal subsidies. The problem, however, is that many of the subsidy pricing decisions are made outside legitimate public policy parameters, and many have not been reviewed for years because Congress is not routinely provided information by the Executive Branch on the real cost of these programs and transactions. In this respect, they're like the Energizer Bunny: they just keep going and going.

Let me give you an example of these losses. Almost every year, the U.S. Forest Service issues a press release announcing how much net revenue, or "profit", the timber sales program made in the past fiscal year. That announcement usually cites hundreds of millions of dollars in "net revenues" to the Treasury. In fact, Mr. Chairman, the Forest Service can claim "net profits" to the Treasury only by way of some creative bookkeeping techniques, and it took extensive investigation for us to learn that fact. When necessary to help show "profits" to the Treasury, the Forest Service accounting system allows them to amortize roads (a major program expense) over 500, 1,200 or -- remarkably -- even 1,800 years. (By comparison to reality, these roads actually last about 25-30 years.) Only the government is allowed to cook its books with such ridiculous and misleading accounting techniques. In the absence of investigations like the one I just mentioned, Congress would have no way of knowing that the timber sales program actually loses hundreds of millions of dollars a year in real money.

This is just one example of the problem, but unfortunately there are plenty more. Mr. Chairman, I submit that Congress shouldn't have to do that kind of extensive investigation to learn the truth about these important budget issues. But we do, because there currently is no requirement that the Executive Branch provide specific information to Congress about the real costs of these transactions in terms of losses to the taxpayers and the subsidies provided to various beneficiaries under these programs.

To correct this deficiency, and to ensure that Congress does have the information it needs to make sensible budgetary and policy decisions about asset-based losses and subsidies, I introduced H.R. 742. It is a very simple bill, based on a simple premise: information is power. In this time of extraordinary concern over the deficit, Congress must have the information it needs to scrutinize each and every federal expenditure or revenue loss.

My bill helps Congress carry out that responsibility, by requiring the Administration, in its annual budget submission to Congress, to include a separate statment of the projected revenues anticipated from the sale, lease, or transfer of any physical asset and, in addition, to include the estimated fair market value of those programs or transactions. This itemization and comparison will disclose to Congress and the public the actual amount anticipated to be lost each year from these transactions, and will allow us to take that information, judge it against the program's benefits to society, and make an informed decision about the merits of each category of loss or subsidy.

Let me emphasize again: I am not against subsidies per se. We know from experience that many are useful and advance important societal goals; these should be retained. But Congress is ill-equipped to make these judgments if we do not know the actual cost of the subsidies. In short, information disclosure is the sole purpose of my legislation. I might add, parenthetically, that the estimates required of the Administration for both expected revenues and the fair market value of these transactions are calculations they are well-equipped to make.

The requirements of the bill are simple, direct, and useful and I hope this Committee will look favorably upon it and adopt it as a free-standing bill or as part of any budget-reform legislation advanced by the Committee.

I would note before closing that the legislation, as currently crafted, does not require a similar informational statement in the budget submission concerning the costs of so-called "revenue expenditures" or tax subsidies. However, in light of Congress' increasing need to probe every nook and cranny of the budget for additional savings and potential sources of revenue, I believe the Committee may want to give serious consideration to expanding the scope of the bill to include such an informational statement concerning tax subsidies.

As the Congressional Research Service testified on February 3, 1993: "Many, perhaps most, [tax expenditures] persist unchanged year after year", even though the conditions that gave rise to them "may frequently bear little relationship to today's conditions".

As I reflect further on the legislation, I believe the same argument can be made concerning these tax expenditures as can be made about resource-based losses: we cannot deal with the facts until and unless we know the facts. In my view, it's high time Congress insisted on knowing the extent of all of these losses-- both resource-based and tax-based --in a clear, concise and honest way. Only then will we be able to scrutinize each and every one and make informed, reasoned judgments about their individual merits.

Many subsidies will be continued by Congress because they advance goals that are important to the public and to the Nation. Others may be cut back or eliminated on grounds that they are no longer justified or are unreasonably costly. But we can not wisely chose between them if we do not know their real cost to the taxpayers.

I strongly urge the Committee to act favorably on H.R.742, so that any budget-related reforms can include this very simple and responsible requirement.

Thank for the opportunity to present this statement in support of H.R.742.

STATEMENT OF
HONORABLE AL McCANDLESS
Ranking Minority Member
Legislation and National Security Subcommittee

November 9, 1993

Thank you, Mr. Chairman. I would like to welcome our witnesses today before the subcommittee.

The debate over capital budgeting has been in this town for as long as Congress has been debating budgets. For as long as I can remember, Congressman Bill Clinger has been calling for the creation of a capital budget within the current unified budget. The National Performance Review recommendations and this hearing should help focus on his efforts.

I look forward to hearing from our witnesses.

JOHN CONYERS, JR., MICHIGAN
CHAIRMAN
CARDISS COLLINS, ILLINOIS
GLENN ENGLISH, OKLAHOMA
HENRY A. WAXMAN, CALIFORNIA
MIKE SYNAR, OKLAHOMA
STEPHEN L. NEAL, NORTH CAROLINA
TOM LANTOS, CALIFORNIA
MAJOR R. OWENS, NEW YORK
EDOLPHUS TOWNS, NEW YORK
WM. M. SPRATT, JR., SOUTH CAROLINA
JIM A. CONDIT, CALIFORNIA
COLLIN C. PETERSON, MINNESOTA
KAREN L. THURMAN, FLORIDA
BOBBY L. RUSH, ILLINOIS
CAROLYN B. MALONEY, NEW YORK
THOMAS M. BARRETT, WISCONSIN
DONALD M. PAYNE, NEW JERSEY
FLOYD H. FLAKE, NEW YORK
JAMES A. HAYES, LOUISIANA
CRAIG A. WASHINGTON, TEXAS
BARBARA-ROSE COLLINS, MICHIGAN
CORRINE BROWN, FLORIDA
MARJORIE MARGOLIES-MEZVINSKY, PENNSYLVANIA
LYNN C. WOOLSEY, CALIFORNIA
GENE GREEN, TEXAS
BART STUPAK, MICHIGAN

ONE HUNDRED THIRD CONGRESS

Congress of the United States
House of Representatives
COMMITTEE ON GOVERNMENT OPERATIONS
2157 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515-6143

WILLIAM F. CLINGER, JR., PENNSYLVANIA
RANKING MINORITY MEMBER
AL McCANDLESS, CALIFORNIA
J. DENNIS HASTERT, ILLINOIS
JON L. KYL, ARIZONA
CHRISTOPHER SHAYS, CONNECTICUT
STEVEN SCHIFF, NEW MEXICO
C. CHRISTOPHER COX, CALIFORNIA
CRAIG THOMAS, WYOMING
ILEANA ROS-LEHTINEN, FLORIDA
DICK ZIMMER, NEW JERSEY
WILLIAM H. ZELIFF, JR., NEW HAMPSHIRE
JOHN M. McHUGH, NEW YORK
STEPHEN HORN, CALIFORNIA
DEBORAH PRYCE, OHIO
JOHN L. MICA, FLORIDA
ROB PORTMAN, OHIO

BERNARD SANDERS, VERMONT
INDEPENDENT

MAJORITY—(202) 225-5051
MINORITY—(202) 225-5074

STATEMENT OF
HONORABLE WILLIAM F. CLINGER, JR.
Ranking Minority Member
Committee on Government Operations

November 9, 1993

Thank you very much, Mr. Chairman.

I have been supporting and proposing capital budgets around here for a good number of years. My legislation, H.R. 1050, simply seeks to identify, define, and present separate operating and capital components of the Federal budget, and to distinguish between Federal funds and trust funds, while maintaining a unified budget. My bill would provide what the existing budget does not. That is, adequate information on the revenues, expenditures, surplus/deficit amounts, and financing requirements for capital activities of the Federal government.

It is my hope that early next year, we will take this issue up again, Mr. Chairman, and pass legislation in support of the Vice President's NPR recommendations to create a capital budget.

I have come to learn that capital budgeting is a difficult issue to discuss around here from a marketing standpoint. It does not share the same attractiveness as do foreign assistance, defense or welfare issues. If you should be so bold as to attempt to sell the idea by couching it in terms of amending the current budget process, as cumbersome and as imperfect as it is, capital budgeting scares away many policy makers for fear that it will further obscure a process they have grown accustomed to criticizing and, perhaps, vaguely understanding.

But in my conversations with policy makers here in Washington, the biggest challenge I find is the need to overcome the uncertainties that arise when the subject of capital budgeting is raised. Frankly, I think the present budget fiasco begs Congress to adopt better methods of developing and implementing an improved budget process. My study of capital budgeting convinces me that this is one reform that, if implemented in a disciplined and well thought-out manner, has great merit because it will have the beneficial effect of clarifying, not obscuring, our Government's spending practices.

The potential for improving information available to policy makers to help guide them during budget deliberations is tremendous. In its most elementary form capital budgeting segregates operational expenses from investment spending. Lawmakers would be able to distinguish how much of an agency;s account is devoted to paying the bills and how much of its funding provides annual benefits.

Capital budgeting would provide a benchmark that policy makers could use to gauge past and present Federal investment in infrastructure, instead of today's practice of debating numbers representing an agglomeration of accounts that hold very little descriptive value about the real effects of cuts or increases. For those of use who subscribe to the belief that more resources must be brought to bear on our Nation's inventory of public works projects, I suggest that capital budgeting would aid us very much in this endeavor. With it we would be able to strictly monitor projects, programs and activities in a way that would permit Congress and the Administration to better allocate scarce Federal resources.

Capital budgeting, if done properly, is not an exercise in "cooking the books." Indeed, it would make such a practice much more difficult. There are some who oppose the idea for the fear that capital budgeting is an illusory gimmick that is designed to understate the deficit, and others argue that the Federal government has not need for capital budgeting since we do not amortize investments. It is my belief that these arguments are misguided objections to what could be a major improvement in our budget process. I hope that as the debate on this and on National Performance Review recommendations progresses, policy makers will be more open to the idea of implementing this worthwhile practice.

It is my hope that members who are persuaded that capital budgeting is a useful tool would be willing to sign on as original cosponsors of my legislation H.R. 1050.

So, Mr. Chairman, I look forward to today's witnesses testifying about the merits of capital budgeting and the drawbacks, if any.

Once again, Mr. Chairman, thank you for convening this hearing.

Mr. SYNAR. Our first panel includes Dr. Robert Eisner, professor of economics, Northwestern University; Dr. Dale Jorgenson, professor of economics, Kennedy School of Government at Harvard; and Dr. David Aschauer, professor of economics at Bates College.

Gentlemen, welcome.

I am sorry for the delay in convening. Welcome. I will tell you, it is normal for the subcommittee I serve as Chair to swear in all the witnesses. I don't think that is the policy here. Although you are not under oath, we expect you to tell the truth this morning.

Professor Eisner, of Northwestern University, was a guest at Bill Clinton's Little Rock Economic Summit to discuss budget and economic issues and we are pleased to have him with us today. Dr. Eisner has written frequently on the subject of Federal investment and productivity.

STATEMENT OF ROBERT EISNER, PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY

Dr. EISNER. I always tell the truth. That may shock a few people.

Private business accounts separate capital from current expenditures. Most State and local governments do that. Almost all foreign governments do that. The Federal Government budget and our national income product accounts do not, and therein hangs a tale.

There is much talk of budget deficits and there have been major efforts to reduce what are purported to be your—our deficits. Deficits do matter. But the failure to distinguish capital from current expenditures contributes to the misleading measures of our deficits and what might be done about them. It obscures from the public information vital to allocation of the Nation's resources. Most importantly, it contributes to a faulty public policy regarding our provision for the future.

The Federal budget is a major culprit. I can point to the S&L fiasco but particularly to accounting for the S&L fiasco which put into the budget varying amounts of so-called outlays which are really portfolio adjustments. It really is as if we, in our personal finances, reported a deficit when we borrow to buy into the stock market. We do not do that. We don't report a surplus when we sell the stock and pay off the debt.

The Federal Government should view and account for these transactions similarly.

Financial capital transactions, however, are only the tip of the capital investment iceberg obscured by Federal Government accounts. Any acquisition of assets, financial or real, is included in the budget as an outlay and thus adds to the "deficit."

Sales of assets are treated as subtractions from outlays which reduce the deficit. This leads to the anomaly that we could eliminate what we call the deficit for a number of years by selling off title to government assets and then leasing them back. We could start with the White House, the Capitol, move on to the Pentagon, and all of our military arsenal; and since we have about $1.6 trillion of government assets and equipment and structures, we can sell off about $300 billion a year for a number of years. Over that period we would have no deficit. Of course, at some point we would run out of assets. Then we would have to figure out what to do for an encore.

A separate capital budget for the Federal Government would generally, although not necessarily always, leave a remaining current account in less deficit than the composite account now presented. The magnitude of the adjustment would depend upon the level of net investment, that is, the amount by which gross investment exceeds the level of depreciation in the existing capital stock.

If the capital budget were to include only investment in equipment and structures, in 1992, the deficit, as calculated by the national income and product accounts, would have been lowered by only a small amount because net investment was so low.

I have a set of tables you might be looking at in conjunction with my remarks.

The great virtue of a capital budget is that it would have alerted us to trends that might warrant attention, such as the very large decrease in the level of Federal net investment and fixed capital from $30 billion in 1987 to $12 billion in 1992.

A capital budget might reasonably include other items where expenditures are made today with an expectation of benefits in the future. We go back to OMB budget figures in fiscal 1990 and 1991. These would comprise a more inclusive $103 billion of direct Federal investment of physical capital, grants to State and local governments for physical capital of some $26 billion, research and development expenditures of $66 billion, and education and training expense of $36 billion.

We put all this investment into a capital budget but, appropriately, put depreciation on federally financed capital, reasonably about two-thirds of gross investment, back into the current budget, we have reduced the OMB measure of "the deficit" by a substantial $78, $80 billion.

Focusing on the composite account for all levels of government, a meaningful capital account would include investment in human and intangible capital as well as fixed capital.

In tables 2 and 3, I project very rough and summary estimates for 1990 and for 1992. We find that the composite Federal, State, and local current budget in 1990, was $25 billion in surplus. Total expenditures exceed total receipts by $140 billion. The amount of the deficit reported in the national official income and product accounts was, thus, related to and equal to the excess of net capital expenditures over the current accounts surplus. In effect, there was a deficit of $165 billion on capital account.

In 1992, the total deficit was a considerably greater $269 billion, but virtually all of this increases involved an increase in the current deficit. It clearly was not related to investment in our future.

I might point out that almost nobody other than government seems to be expected to finance capital investment out of current income. If we did that, we would not have the housing stock in this country; perhaps we would be like the Japanese. If everybody in this room had to wait to buy a house until they had their capital—their money in hand and couldn't borrow, most of them would not be buying houses until close to retirement perhaps.

Businesses, if they couldn't borrow, raise capital from outside, had to rely on retained earnings, would have far less investment.

There is a real question as to why we would want to bind the Federal Government alone to a criterion where it has to worry about a deficit if the deficit is used to finance investment.

What is particularly important, I might add, is how all this translates into total saving and investment accounts, that is, if we have a capital budget for government. That is shown on tables 4 and 5. We can compare the conventional official saving and investment account with an extended measure that includes gross public domestic investment.

The extended measures of tables 4 and 5 are still narrow measures of saving. And if they exclude nongovernment investment in R&D, education, training, household investment, and durable goods, they do include gross public investment on the investment side of the account and the saving that corresponds to it on the other.

That makes clear the following: Increasing current expenditures reduces net public saving, as in 1990, or increases the net public dissaving, as it would be doing in 1992. Unless private saving is increased, possibly as a result of increases in income, total or national saving must decline.

But increases in government capital expenditures, on the other hand, must increase national saving unless they implausibly bring about equal or greater decreases in the sum of private domestic and net foreign investment.

Introduction of a capital budget to the account puts a different light on the much misunderstood issue of government deficits and their effect on national saving. The Bureau of Economic Analysis of the Department of Commerce is, indeed, now working on the presentation of accounts that separate government current expenditures from government capital product accounts.

This would be in line with United Nations' system of national accounts followed by most other nations. But currently the government deficit in the national income and product accounts is treated as a direct offset to private saving. The assertion is routinely made that the greater the deficit, the less is total saving and, along with it, total investment.

This is, in fact, a dubious proposition as actions to reduce the deficit, either by raising taxes or cutting expenditures, are likely to depress the economy and, hence, reduce private investment and saving.

A capital budget for the government sector, with associated revisions of the saving and investment account, would highlight the impact of public investment on gross investment. Reduction of the conventional "deficit" by reducing government investment spending is virtually certain to reduce total investment and, hence, contrary to much conventional wisdom, reduce national saving and increase the burden we pass to the future.

Thank you.

Mr. SYNAR. Thank you very much, Doctor.

[The prepared statement of Dr. Eisner follows:]

Corrected

November 7, 1993

Congress of the United States

House of Representatives

Committee on Government Operations

Legislation and National Security Subcommittee

Statement Prepared for Hearings on November 9, 1993

Capital Budgeting for Government

Robert Eisner

Robert Eisner is the William R. Kenan Professor of Economics at Northwestern University and a past president of the American Economic Association. He is the author of *How Real Is the Federal Deficit?*, *The Total Incomes System of Accounts* and, forthcoming, *The Misunderstood Economy: What Counts and How to Count It*.

November 7, 1993

Capital Budgeting for Government
Robert Eisner

Private business accounts separate capital from current expenditures. State and local governments generally do. The Federal government budget and our national income and product accounts do not, and therein hangs a tale.

There is much talk of budget deficits and there have been major efforts to reduce what are purported to be our deficits. Deficits do matter. But the failure to distinguish capital from current expenditures contributes to misleading measures of our deficits and what might be done about them. It obscures from the public information vital to allocation of the nation's resources. Most important, it contributes to faulty public policy regarding our provision for the future.

Take the Federal budget, which is the major culprit. We were told to anticipate a deficit of $400 billion in fiscal year 1992. But it turned out that this included some $80 billion of outlays for "deposit insurance," which were essentially financing of a liability already incurred in Government guarantees of Savings and Loan Bank deposits. If we kept a balance sheet of government assets and liabilities, this would properly show up in a shuffling of the portfolio, no current change in net worth and no entry at all in the current account. This is indeed recognized implicitly in the Administration's budget by separate measures of the "deficit" without deposit insurance, and by the Bureau of Economic Analysis in excluding purely financial transactions outright. If the Federal government eliminated these purely financial capital transactions from its measure of the deficit, it would prevent these confusing variations in reported deficits as varying amounts of them enter the budget or the actual amounts vary from what is budgeted. We do not in our personal finances report a "deficit" when we borrow to buy into the stock market.

And we do not report a surplus when we sell the stock and pay off the debt. The Federal government should view and account for these transactions similarly.

Financial capital transactions, however, are only the tip of the capital investment iceberg left out of Federal government accounts. Any acquisition of assets, financial or real, is included in the budget as an outlay and thus adds to the "deficit." And sales of assets are treated as subtractions from outlays which reduce the deficit. This leads to the anomaly that one could eliminate the deficit for a number of years by selling off title to government assets and then leasing them back. We could start with the White House and Capitol, go on to the interstate highway system and Federal lands and perhaps conclude by selling all of our military hardware back to our defense contractors. The Federal government currently owns more than $1.6 trillion in fixed reproducible capital -- equipment and structures -- alone. If we sold-leased-back this equipment and structures to the amount of several hundred billion dollars a year, we could show a "balanced budget" for a number of years, until we ran out of assets!

The Federal government ought to have a capital budget. Businesses' income statements include only current expenditures and capital depreciation, not the outlays for new machinery or the building of factories. State and local governments are generally required to balance current operating budgets but keep separate capital accounts.

A separate capital budget for the Federal government would generally, although not necessarily always, leave a remaining current account in less deficit than the composite account now presented. The magnitude of the adjustment would depend on the level of net investment -- that is, the amount by which gross investment exceeds the level of depreciation in the existing capital stock. If the capital budget were to include only investment in equipment and structures,

the 1992 deficit as calculated in the national income and product accounts would have been lowered by only a small amount because net investment was so low. (See Table 1.) In prior years, the change would have been more substantial. The great virtue of a capital budget is that it would have alerted us to trends that might warrant attention -- such as the very large decrease in the level of Federal net investment in fixed capital from $30 billion in 1987 to $12 billion in 1992.

A capital budget might reasonably include other items where expenditures are made today with an expectation of benefits in the future. Taking OMB budget figures in fiscal 1991, these would comprise a more inclusive $103.5 billion for direct Federal investment in physical capital, grants to state and local governments for physical capital of $26.5 billion, research and development expenditures of $66.0 billion, and education and training expense of $35.8 billion. If we put all of this investment into a capital budget but, appropriately, put depreciation on Federally-financed capital, reasonably about two-thirds of gross investment, back into the current budget, we would reduce the OMB measure of "the deficit" by a substantial $77.9 billion.

Focusing on the composite account for all levels of government, a meaningful capital account would include investment in human and intangible capital as well as fixed capital. In Tables 2 and 3, I have projected some very rough and summary figures for 1990 and for 1992 to show what such an account might look like. We find that the composite Federal, state and local current budget in 1990 was $25 billion in surplus. Total expenditures exceed total receipts by $140 billion, the amount of the deficit reported in the official national income and product accounts, but this related to and was equal to the excess of net capital expenditures over the current account surplus. In effect, there was a deficit of $165 billion on capital account.

4

In 1992, the total deficit was a considerably greater $269 billion but Table 3 indicates that all of this increase could be accounted for by a move in the current account from that $25 billion surplus to a deficit of $97 billion -- a $122 billion swing, a great portion due to the deterioration of the economy. It clearly was not related to investment in our future.

What is particularly important is how this translates into total saving and investment accounts, shown in Tables 4 and 5. Here we can compare the conventional, official saving and investment account with an extended measure that includes "gross public domestic investment" along with gross private domestic investment. The extended measures of Tables 4 and 5 are still narrow measures of saving in that they exclude non-government investment in R&D and education and training as well as household investment in durable goods. But they include gross public investment on the investment side of the account and the saving that corresponds to it on the other. This makes clear the following:

- # Increasing current expenditures reduces net public saving (the 1990 current surplus of Table 2) or increases net public *dis*-saving (the 1992 current account deficit of Table 3). Unless private saving is increased, possibly as a result of increases in income, total or national saving must decline.

- # Increases in government capital expenditures, on the other hand, must increase national saving unless they implausibly bring about equal or greater decreases in the sum of private domestic and net foreign investment.

Introduction of a capital budget to the government account puts a quite different light on the much misunderstood issue of government deficits and their effect on national saving. The Bureau of Economic Analysis of the Department of Commerce is indeed now working on the presentation of accounts that separate government current expenditures from government capital expenditures. This would be in line with the United Nations System of National Accounts followed by most other nations. But currently the government deficit in the national income and

product accounts is treated as a direct offset to private saving. The assertion is routinely made that the greater the deficit, the less is total saving and along with it, total investment. This is in fact a dubious proposition, as actions to reduce the deficit, either by raising taxes or cutting expenditures, are likely to depress the economy and hence reduce private investment and saving.

A capital budget for the government sector, with associated revisions of the saving and investment account, would highlight the impact of public investment on gross investment. Reduction of the conventional "deficit" by reducing government investment spending is virtually certain to reduce total investment and hence, contrary to much conventional wisdom, reduce national saving and increase the burden we pass to the future.

Table 1. Federal Government Investment in Fixed Capital, 1987, 1990, 1991, 1992

(Billions of Dollars)

	1987	1990	1991	1992
Gross Investment	76.3	73.6	72.6	71.2
Depreciation	46.3	53.4	56.4	59.3
Net Investment	30.0	20.2	16.1	11.9

Source: Bureau of Economic Analysis, "Fixed Government Capital (including residential) historical-cost valuation, gross investment, depreciation and net investment," Federal.

7

Table 2. Government Receipts and Expenditures Account, 1990

(Billions of Dollars)

Current Account			
Credits: Revenues			1,697
Charges: Current Expenditures			1,672
Goods and Services		549	
Net Interest, Transfer Payments and Other		794	
Consumption of Capital		329	
Surplus or Deficit (-)			25
Capital Account			
Credits: Consumption of Capital			329
Charges: Gross Capital Expenditures			494
Tangible		187	
Intangible		307	
Education	245		
R & D	62		
Net Capital Expenditures			165
Surplus or Deficit (-)			-165
Consolidated Account			
Revenues			1,697
Expenditures			1,837
Total Surplus or Deficit (-)			-140

Sources: National Income and Product Accounts, Survey of Current Business, January 1992, p.42; "Government Expenditures by Function," Table 3.15, Survey of Current Business, January 1992, p.48; Bureau of Economic Analysis, "Fixed Government Capital (including residential) historical-cost valuation, gross investment, depreciation and net investment," total. National Science Foundation, Federal funds for research and development: fiscal years 1989, 1990 and 1991, volume XXXIX, Table C-1, p.35; U.S. Department of Commerce, Government Finances, December 1991, Tables 4 and 5, pp. 4,6. Intangible capital consumption allowances assumed equal to two-thirds of gross intangible capital expenditures.

8

Table 3. Government Receipts and Expenditures Account, 1992
(Billions of Dollars)

Current Account			
Credits: Revenues			1,849.4
Charges: Current Expenditures			1,946.1
Goods and Services		601.8	
Total	1,131.8		
Minus Cap. Exp.	530.0		
Net Interest, Transfer Payments and Other		986.7	
Consumption of Capital		357.6	
Surplus or Deficit (-)			-96.7
Capital Account			
Credits: Consumption of Capital			357.6
Tangible	135.4		
Intangible	222.2		
Charges: Gross Capital Expenditures			530.0
Tangible	196.7		
Intangible	333.3		
Education	261.7		
R & D	71.6		
Net Capital Expenditures			172.4
Surplus or Deficit (-)			-172.4
Consolidated Account			
Revenues			1,849.4
Expenditures			2,118.5
Total Surplus or Deficit (-)			-269.1

Sources: National Income and Product Accounts, Survey of Current Business, September 1993, p. 12, Tables 3.2 and 3.3, Federal and State and Local Government Receipts and Expenditures, respectively; pp. 30, 32, 34, Tables 3.15, 3.16 and 3.17, "Government Expenditures by Function," "Federal Government Expenditures by Type and Function," and "State and Local Government Expenditures by Type and Function"; Bureau of Economic Analysis, from John Musgrave, "Fixed Government Capital (including residential) historical-cost valuation, gross investment, depreciation and net investment," total; National Science Foundation/SRS, National Patterns of R&D Resources: 1992, pp. 47,48, Tables B-2 and B-3, and data and estimates from Carol Evans of Bureau of Economic Analysis; consumption of intangible capital assumed equal to two-thirds of gross intangible capital expenditures.

9

Table 4. Extended Gross Saving and Investment Account, 1990

(Billions of Dollars)

Gross Private Domestic Investment	803	Net Private Saving		257
		Personal Saving	207	
Gross Public Domestic Investment	494	Business Saving	50	
Net Foreign Investment	-83	Net Public Saving		25
		Capital Consumption Allowance		924
		Private	595	
		Public	329	
		Statistical Discrepancy		8
Gross Investment	1,214	Gross Saving and Statistical Discrepancy		1,214

Sources: Table 2, above, and National Income and Product Accounts, Table 5.1.--Gross Saving and Investment, Survey of Current Business, January 1992, p.58.

10

Table 5. Extended Gross Saving and Investment Account, 1992

(Billions of Dollars)

Gross Private Domestic Investment	796.5	Net Private Saving		329.0
		Personal Saving	238.7	
Gross Public Domestic Investment	530.0	Business Saving	90.3	
Net Foreign Investment	-55.1	Net Public Saving		-96.7
		Consumption of Capital		1,015.5
		Private (Fixed)	657.9	
		Public	357.6	
		Statistical Discrepancy		23.6
Gross Investment	1,271.4	Gross Saving and Statistical Discrepancy		1,271.4

Sources: Table 3, above, and *Survey of Current Business*, August 1993, p. 55, Table A.—Summary National Income and Product Acccounts, 1992, Account 5.—Gross Saving and Investment Account.

Mr. SYNAR. Our next witness is Dr. Dale Jorgenson. Dr. Jorgenson joins us this morning from Harvard University, where since 1969, he has been a professor in the economics department. Additionally, Dr. Jorgenson directs the Harvard University Kennedy School of Government program on technology and economic policy. Dr. Jorgenson, please proceed.

STATEMENT OF DALE W. JORGENSON, PROFESSOR OF ECONOMICS, KENNEDY SCHOOL OF GOVERNMENT, HARVARD UNIVERSITY

Dr. JORGENSON. I am very pleased to participate in these hearings.

At the outset, I think it is useful to consider the very limited role capital budgeting has under the current budgetary structure.

I would like to make three points. I would like to outline the role of capital budgeting as it currently exists. I would like to discuss the issue of implementing a capital budgeting scheme like the one that is under consideration by this subcommittee. And I want to take, as an example, investment in human capital which is an area where I have had substantial experience. Third, I would like to discuss the limitations of capital budgeting as a solution to the budget crisis that has resulted over these many years from the Reagan tax cuts of 1981.

Let's begin, then, with the role of capital budgeting. The only capital budgeting concept that has a statutory role in the current process is the debt ceiling. This ceiling has been totally ineffective in dealing with the crisis that we confront. The debate over the Clinton budget plan, which ended when the President signed the Omnibus Budget Reconciliation Act of 1993 into law on August 9, focused almost exclusively on the deficit and ignored the debt ceiling or treated it as an afterthought.

As part of this legislation, as you know, the debt ceiling was raised to $4.9 trillion. But this limit, in fact, will be exceeded in fiscal year 1995 according to the Congressional Budget Office.

I think a more useful indicator, one published by the CBO, is that debt held by the public in relationship to the gross domestic product or the GDP. This provides a very useful indicator of the development of our budgetary crisis.

In 1994, after a long decline, the proportion of debt held by the public was 45.5 percent of the GDP. It almost doubled over the decade of the 1980's during the period following the Reagan tax cuts. By the end of 1993, it rose to 52.5 percent of our gross domestic product.

Well, the conclusion is that using a system of capital budgeting, whatever its desirability, would involve a wrenching change in the budgetary mechanism. It would involve changes at every level. It would involve the OMB, the Congressional Budget Office, the budget committees of the Congress. And it would involve all of the many committees that are involved in the appropriations process.

So we are talking about a very, very major change. Capital budgeting plays a very limited and ineffectual role in the existing budgetary system. To shift to a system where capital budgeting was used by statute would involve changing the functioning of our government, especially the Congress.

I would like now to proceed to my second point. My second point is the approach to capital budgeting that I think should be considered. Capital budgeting should provide a complete picture of the assets and liabilities of the Federal Government.

This information is, in fact, now regularly reported by the Board of Governors of the Federal Reserve system. The Board of Governors prepares a national balance sheet for the United States that includes separate balance sheets for a number of its most important components, including the private sector, State and local government, taken collectively, and the Federal Government itself.

The Bureau of Economic Analysis, which has responsibility for the national accounts, produces a good bit of the information that goes into the national balance sheet as it relates to the Federal Government.

Finally, the Office of Management and Budget provides a comprehensive view of investment which includes not only investment in tangible assets but investment in loan programs, financial assets, investment in research and development, and investment in human capital.

This is part of the special analyses section of the annual budget submission to the Congress. I have to lament the fact that, surprisingly, the Office of Management and Budget does not even refer to the national balance sheet prepared by the Board of Governors.

It is as if the investment of the Federal Government is isolated from its assets, which applied at the business level would drive any accountant directly to incarceration. That would be against the law, to say the least.

Well, to proceed then, what I would like to do is to look at the problem of human capital. This is a central issue in our whole investment portfolio and illustrator of the kind of problems that arise in implementing capital budgeting.

I want to refer specifically to the role of investment in human capital as investment, that is to say, as a current expenditure, and the role of human capital as part of a national balance sheet. This is an area where Professor Eisner has done very important research. It is a very active area of research among economists. And what I will refer to here is the results of research that I have done with my colleague Barbara Fraumeni. This is in print, and I refer to it in the published—the written version of my testimony.

Well, let's proceed, then, to look at a few numbers that indicate the nature of the problem. First of all, just to fix ideas, the value of the private sector's balance sheet, the asset side of the private sector, is some $16 trillion. That is what you would find in the year 1986 if you picked up the national balance sheet from the Board of Governors.

What is the value of human capital? The value of human capital is more than 10 times as great. I estimate the value of human capital in that year to be $270 trillion. How can this number be so large?

Well, it represents the lifetime incomes in both market and nonmarket activities of the whole U.S. population. That is the appropriate balance sheet concept of human capital.

Now let's look at the issue of investment. The national product in 1986, again to fix ideas, was $4.2 trillion. That is the national

product. In that same year, investment in schooling alone was $3.8 trillion. That represents the addition to individuals' lifetime incomes as a consequence of enrollment in school and figures out to be $65,000 for each individual enrolled in school.

How does that compare with the outlays on human capital of all Federal, State, and local governments? In that year, 1986, those outlays totaled $277 billion. That turns out to be about 6.5 percent of the national product and about 7.3 percent of investment in human capital through education.

What I would like to submit is that this government investment is analogous to an investment tax credit, not to an accumulation of a government asset. It is like the investment tax credit of 10 percent on equipment that was available under the Internal Revenue code for private investments through December 31, 1985.

The rest of the value of investment in human capital, by far the most of it, is primarily the dedication of time by individuals who enrolled in school to education rather than other activities. To take the balance sheet approach, ask yourself the simple question, does the investment result in something that ends up on the balance sheet of the Federal Government? The answer is that investment in human capital does not.

Why not? Because investment in human capital results in an asset that ends up on the private balance sheet of the individuals who receive that investment, namely individuals enrolled in school. This is no great mystery. These people, have to pay taxes on their labor incomes. This is a very large part of the income they generate over their lives; but it is their labor, their income, and it is their human capital.

So the conclusion is that the role of government is to provide part of the expenditures to finance the out-of-pocket costs, which are by far the smallest part of the total expenditures on human capital so that capital budgeting by the Federal Government should be based, first of all, on a balance sheet for the Federal Government. The Board of Governors puts a balance sheet like that together every year. What is mysterious is the fact that outlays on human capital are included by the Office of Management and Budget, the official administration agency in charge of preparing the budget of the Federal Government.

Investment in human capital is treated as an investment by the Federal Government. That is simply wrong from the accounting point of view. Government outlays are a way of financing private investment, just as the investment tax credit was a way of financing private investment on equipment. The most important part of that investment is financed by the individuals and ends up on the balance sheet of those individuals.

So the key test, then, is to ask yourself the question: What will end up on the Federal Government's balance sheet? That, then, leads to the answer as to what should be eligible for capital treatment under a capital budgeting plan.

The third issue I would like to discuss is the appropriate way to look at the costs of financing government expenditures. As Professor Eisner reminded us, not all government expenditures are the same but they all share one property in common, that is, that they have to be financed out of tax revenues either now or in the future.

So the question is: What is the cost that we should use in evaluating investments, and what is the cost that we do use?

What we have here is a picture of the impact of the tax system on the growth opportunities faced by the private sector of our economy. What I have done is to simply analyze the tax system by asking a very simple question: What is the impact of $1 of tax revenue that is dedicated to Federal Government investment or to current expenditures of the government sector? What is the effect of that on the growth opportunities that are faced by our economy, the growth opportunities for future consumption either by the government itself or by the private sector?

The answer is that, on average, a tax dollar costs not only $1 of revenue which is not available for the private sector but an additional cost of 39 cents on the dollar that is due to the distortions that are induced by the way government spending has to be financed, namely through taxes. This is a hidden cost that results from the fact that when an individual with an accumulation of human capital, say through formal schooling, enters the labor market to generate income, that individual faces the Internal Revenue Service; the Internal Revenue Service will collect, at a margin, about 30 cents out of every $1 earned by an individual in the labor market.

That results in a disconnect between the value of that individual's labor market activities to the economy, which are before taxes and the incentive that individual has to provide these later services to the economy. If you apply that principle throughout the Federal tax system, what you find is that the marginal costs of 39 cents on the dollar is much higher for some revenue sources than for others. For example, the cost of raising tax dollars through capital income taxes at the individual level is more than $1 for every dollar raised.

In other words, when you think about $1 of tax revenue raised by taxing capital income at the individual level, it costs the economy $2; $1 goes to the government, another $1 results in waste as a result of this hidden cost. The costs of raising $1 from hidden income is about 37 cents.

If we look at the taxes that are raised on other programs, mainly used by State and local governments, we find that, at the State and local level, sales taxes measured in the same way impose a burden on the economy of only $1.26. In other words, $1 of tax revenue results in 26 cents of a hidden cost.

So far as property taxes are concerned, much maligned in the State of Michigan, these cost only 17 cents on the dollar. So the conclusion is that the hidden costs of taxation is something that has to be included in any resolution of the budget crisis.

The Federal Government relies very heavily on income taxes as a revenue source. That turns out to be the most expensive form of tax revenue to be used. The main revenue sources of the State and local governments in this country are sales and property taxes. Those turn out to be the low-cost sources of government revenues that can be devoted either to investment or financing current expenditures.

What is needed in order to bring the budget into balance is an attention to the cost side as well as the expenditure side of the government budget. Expenditures, whether on current account or on

capital account, must incorporate the hidden costs that are due to the way in which we have to generate money to pay for government outlays, whether these outlays occur at the Federal level or State and local level.

So my conclusions are the following: First of all, capital budgeting is a very worthwhile proposal. It deserves serious consideration from the Congress. I am very, very pleased this committee has taken up the charge.

Second, capital budgeting would involve a very major change in the way we do business. It would involve every person in the Congress relearning the whole approach to budgetary structure. It would involve new institutions in addition to the OMB and the Congressional Budget Office possibly as part of those institutions that would generate the information that is required.

But there is ample precedent for doing this. As I mentioned before, the Board of Governors of the Federal Reserve system already prepares the information that is required. It provides a balance sheet for the Nation that includes the Federal Government as a separate category. The balance sheet information is already available.

Furthermore, the Federal Reserve Board of Governors prepares flow funds that identifies not only the investments but also the additions to Federal liabilities that then generate the balance sheet items that appear at the end of every year. What is very disturbing, though, is the fact that capital budgeting has been approached by OMB in its special analyses as a kind of addendum to the Federal income statement.

OMB adds investment items like investment in human capital that should appear as additions to private balance sheets. That shows a conceptual confusion that has to be eradicated before this activity can move forward.

My first conclusion is that the most important single principle that has to be applied to capital budgeting is to use the balance sheet approach, to focus on the issue of what adds and what subtracts to the balance sheet of the Federal Government.

My second conclusion is that we are in a serious budget crisis. The one indicator that represents a balance sheet item regularly reported by the Congressional Budget Office is the relationship of Federal Government debt held by the public in relationship to the national product. That has steadily increased ever since 1974. It exploded during the 1980's. That is what the budget crisis is about.

But in looking at the framing of budget policy, it is very important to focus not only on investment but also on the financing of investment. This is a well-known problem that many economists have focused on. It is something on which there are reliable figures, some of which I have described for you. They all lead to a similar set of conclusions.

The first conclusion is that the most expensive form of government financing is precisely the form that played the most important role in the Clinton budget plan, namely taxes on capital at the individual level. This is like somebody who is driving a clunker who decides to go to the automobile dealership to buy a new car and, charmed by the sales person, decides to pick out the most ex-

pensive model. A person who should be driving a Chevy, in other words, ends up buying a Cadillac.

That is precisely what happened in the legislation just enacted. For every $1 of tax revenue—and there were something like $250 billion of them—there was $1 in lost growth opportunities imposed on the U.S. economy by the Clinton budget plan. So part of any resolution of the budget crisis has to look at the financing of investment.

If you look at the structure of revenues in the government sector, it is very clear that we have to begin immediately to transfer sizable amounts of our activities to those units of government which have the least cost revenue options. Those, in fact, are the State and local governments. That has to be part of any resolution of the budgetary crisis that we confront.

So my overall conclusion is that this is a very, very relevant and timely set of hearings. What we need in this country is much more focus on the long run and on investment.

If we look at the amount the role of the government in investment, it is something that we can quantify and clarify by means of the simple concept of the balance sheet. We have to give the government a balance sheet as well as an income statement.

That, it seems to me, is the basic thrust of these hearings. I am very, very glad to be able to join with you.

[The prepared statement of Dr. Jorgenson follows:]

November 9, 1993

CAPITAL BUDGETING FOR THE FEDERAL GOVERNMENT?

by

Dale W. Jorgenson

Harvard University

Prepared for presentation

to the

Legislation and National Security Subcommittee

Committee on Government Operations

U.S. House of Representatives

CAPITAL BUDGETING FOR THE FEDERAL GOVERNMENT?

by

Dale W. Jorgenson

1. Introduction.

I am very pleased to participate in hearings by the Legislation and National Security Subcommittee of the Committee on Government Operations. The purpose of these hearings is to consider the introduction of capital budgeting by the federal government. Capital budgeting would divide the consolidated federal budget into separate accounts for capital and current expenditures. This treatment might also be considered for "off-budget" items, such as the social security trust funds and federal government enterprises. In my testimony I will analyze the feasibility and desirability of introducing capital budgeting as a means of redirecting budget policy so that it can contribute more effectively to achieving national policy objectives.

At the outset I think it is useful to consider the limited role of capital budgeting under the existing budgetary structure. The only element of a capital budget that has a statutory role under current policy is the debt ceiling. The debt ceiling provides limits on the debt that can be issued by the federal government. In principle the debt ceiling could become a binding constraint on federal government borrowing that might force the Congress to reduce expenditures or increase revenues. However, the debt ceiling was in force throughout the explosion of government debt of the past two decades and has had little apparent effect in instilling budgetary discipline.

The debt ceiling was raised as part of the Omnibus Budget Reconciliation Act of 1993 (OBRA), enacted by the Congress and signed into law by President Clinton on August 9 of this year. According to the most recent projections by the Congressional Budget Office (CBO), the current limit of 4.9 billions will not be exceeded until fiscal 1995. The focus of the recent debate over the Clinton Budget Plan and debates over its predecessors – the Gramm-

Rudman-Hollings legislation of 1985 and 1987 and the Budget Enforcement Act of 1990 – was almost exclusively on the federal deficit. Upward revision of the debt ceiling was instituted by the Congress as required to accommodate record deficits.

A more useful budgetary indicator provided by the CBO is the debt held by the public as a percentage of the gross domestic product (GDP). Debt held by the public is a useful supplement to information on the deficit itself, since this debt represents claims on the government that must be financed out of private national wealth. Historical data reveal that this ratio declined rapidly during the first three decades of the postwar period, with debt held by the public as a percentage of the GDP reaching a minimum in 1974 at 24.5 percent. This percentage was fairly stable during the 1970's, but almost doubled in the eleven years that followed the tax reductions instituted under President Reagan in 1981.

My first conclusion is that a capital budget for the federal government would represent a drastic change in the mechanism for arriving at federal budgetary policy. Although the information on federal assets and liabilities required for such a policy can be generated fairly readily, this information has played an insignificant role in major budgetary changes, such as the Clinton Budget Plan and its numerous predecessors. The information now available plays an extremely limited role in budgetary deliberations. The debt ceiling and federal debt held by the public stand in splendid isolation as the only information routinely provided to the Congress by its own budgetary agency, the Congressional Budget Office. Only the debt ceiling has a statutory basis.

2. Capital Budgeting.

The United States is one of the few advanced nations that does not employ capital budgeting at the federal level. The proposal under consideration in these hearings is to separate the expenditures of the federal government into separate budgetary accounts to reflect capital and current outlays. This proposal would introduce a useful link between the revenues and expenditures of the federal government and the corresponding assets and liabilities that could comprise a government balance sheet. Federal debt held by the public provides a helpful but incomplete indicator of outstanding liabilities. To be useful as a guide to budgetary policy, capital budgeting should provide complete information on both assets and liabilities.

The Bureau of Economic Analysis of the U.S. Department of Commerce, which has responsibility for the U.S. National Income and Product Accounts, prepares estimates of government investment in tangible assets at both federal and state and local levels. BEA also prepares estimates of stocks of these assets that can be included in a national balance sheet. The Board of Governors of the Federal Reserve System prepares a national balance sheet that incorporates a government sector, again divided between federal and state and local governments. This is accompanied by a flow of funds that includes information on the growth of both assets and liabilities of the federal government.

A more comprehensive measure of investment is provided in the Special Analyses section of the annual budget submissions by the Office of Management and Budget (OMB), as required by an act of Congress. This includes federal investment in tangible assets as well as investment in loan programs, research and development, and human capital. However, an important limitation of the OMB Special Analyses is that the information on investment is not integrated with a balance sheet for the federal government. Although federal investment in tangible assets and loan programs can be related to entries in the Board of Governors balance sheet for the federal government, there are no balance sheet entries corresponding to research and development and human capital.

Human capital investment provides a valuable illustration of the problems that arise in capital budgeting. The greatest part of this investment is in formal schooling, primarily in public schools and institutions of higher education. In collaboration with Barbara Fraumeni I have constructed estimates of investment in human capital and the stock of human capital that are appropriate for inclusion in an expanded system of national accounts and a national balance sheet. Our estimates are based in increments in lifetime incomes of individuals undergoing schooling and incorporate the costs of schooling that appear as outlays of federal, state, and local governments.

From the perspective of these hearings the salient feature of investment in human capital is that lifetime incomes of individuals who benefit from schooling are assets of the individual and not the governmental unit that provides the education. In effect, investment in human capital by the government is like a subsidy or tax expenditure for investment in tangible assets. Government outlays on schooling reduce the cost of investment in human capital for the individual making the investment. However, the resulting asset is the lifetime income of the individual, just as the asset that results from governmental subsidized private investment in tangible assets is the property of the individual or corporation purchasing the subsidized asset.

A few numbers may be helpful in illustrating the role of the government in investment in human capital. First, in 1986 the value of all tangible assets in the private sector of the U.S. economy was sixteen trillion dollars. In that year the value of human capital was more than ten times as great -- two hundred seventy trillion dollars! This staggering figure represents the lifetime market and nonmarket labor income of the whole U.S. population. In 1986 the national product was $4,230 trillion; investment in schooling alone was $3,780 trillion or $65,300 dollars for each individual enrolled in school. Of this amount $277 billion represented outlays of federal, state, and local governments on human capital. This was 6.5 percent of the national product in 1986.

One approach to capital budgeting would be to include expenditures on education by

governments – $277 billion – as an investment of the government sector. However, this investment generates an asset for the private sector, not for the government sector. The private investment totals $3,780 trillion; the government subsidy to this private investment amounts to $277 billions or 7.3 percent of the total. This is analogous to an investment tax credit for private investment in schooling, like the ten percent investment tax credit for equipment available under the U.S. Internal Revenue Code through the end of 1985. The bulk of investment in human capital is privately financed, mainly through the dedication of time by individuals enrolled in school to education rather than other activities.

Time devoted to schooling is critical to the quality of our labor force and the future of our nation. This is reflected in a proper accounting for our national wealth, where human capital exceeds the value of all tangible assets by an order of magnitude. However, investment in human capital is part of the accounts of the private sector of the U.S. economy, not the government sector. Increments in human capital that result from this investment should be entered in the balance sheets of the private sector, not the government sector that provides the schooling. Government expenditures on schooling reduce the cost of private investments, but do not add to the assets of the government sector.

My second conclusion is that capital budgeting by the federal government should be based on a balance sheet for the federal government. Investment outlays should be defined as government expenditures that add to the assets or reduce the liabilities of the federal government. The acquisition of tangible assets by the federal government – structures, equipment, land, and inventories – provide unambiguous illustrations of investment outlays that would satisfy this definition. By contrast, outlays on human capital, apparently regarded as government investment by OMB, provide an illustration of governmental subsidies to the acquisition of assets by the private sector, including the immensely valuable assets that result from education of the U.S. population.

3. Financing Government Expenditures.

The next question I will consider in this testimony is the cost of financing government expenditures. The Clinton Budget Plan signed into law on August 9 will cut the federal government budget deficit by nearly $500 billion dollars over a period of five years, according to CBO. The purpose of deficit reduction is to revive U.S. economic growth by stimulating private investment, the most important source of growth. To stimulate investment further, the tax burden must be shifted from investment to consumption. Unfortunately, the tax increases imposed by the Clinton Budget Plan will increase the tax burden on investment, rather than consumption, thereby offsetting rather than reinforcing the impact of deficit reduction.

The Congressional Budget Office has analyzed the budgetary impact of the Clinton Budget Plan in its mid-year update of THE ECONOMIC AND BUDGET OUTLOOK, published in September. This shows a gradual decline in the federal deficit until 1996, but an uninterrupted increase in debt held by the public as a percentage of the GDP. This percentage is projected to reach 58.7 percent by the end of fiscal 2003, an increase of 6.2 percentage points, relative to the end of 1993, the fiscal year we completed on September 30 of this year. This trend accelerates considerably toward the end of the period after stabilizing briefly in the period 1996-1998.

In the aftermath of the spirited and highly dramatic debate that preceded enactment of the Clinton Budget Plan it is useful to recall the original objectives of deficit reduction. The U.S. economy is subject to the same accounting identity as any other economy -- saving must be equal to investment. This mundane observation is relevant to budget policy, since the federal deficit, like private investment in new assets like plant and equipment, represents a claim on private savings. By cutting the deficit more resources are made available for private investment in new assets, which happens to be the most important source of U.S. economic growth. However, the Clinton Plan has nullified a major part of the benefits from deficit reduction by sharply increasing the burden of taxation on investment.

I next provide a more precise assessment of the cost of financing government expenditures, based on a paper, "The Excess Burden of U.S. Taxation", that I published with Kun-Young Yun in 1991. In this paper we link tax induced losses in economic efficiency directly to U.S. economic growth. We use a nondistorting tax system as a benchmark in measuring the loss in efficiency from taxation. In this tax system all revenue is raised by purely hypothetical taxes that do not distort private decisions and involve no efficiency loss. By focusing on differences in losses among alternative tax programs, we identify the least costly sources of revenues for financing government programs.

The loss in efficiency imposed on the U.S. economy by the current tax system is very large. The efficiency loss is equivalent to eighteen percent of government tax revenue. Each dollar of tax revenue costs the private sector a dollar of foregone investment or consumption and an additional loss in growth opportunities of eighteen cents. We call this estimate the *average excess burden*, defined as the gain in efficiency that would result from replacing the whole U.S. tax system by a nondistorting system. Let me hasten to emphasize that this replacement is purely hypothetical.

The concept of efficiency loss most relevant to budgetary policy is the *marginal excess burden*. The marginal excess burden of the U.S. tax system is defined in terms of the efficiency loss *per dollar* for the final dollar of revenue raised. The marginal excess burden enables us to quantify one of the most familiar propositions in tax policy analysis. Since efficiency losses rise as tax burdens increase, the marginal cost of raising tax revenue is much greater than the average cost. We estimate that the marginal efficiency loss is 39.1 cents per dollar of revenue, more than double the average loss.

Most important, large differences in marginal excess burdens among different tax programs exist. For example, the marginal cost of raising a dollar through taxes on capital income at the individual level is one dollar and 1.7 cents, while the cost of raising a dollar from labor income taxes is only 37.6 cents. For every dollar of tax revenue transferred from capital income to labor income, the U.S. economy *gains* 64.1 cents in future growth opportunities.

This transfer would be revenue neutral, so that it would be in perfect conformity to the Clinton Budget Plan. This provides a clear indication of important potential gains in future U.S. economic growth through increasing the reliance on less costly revenue sources for financing government expenditures.

The marginal efficiency cost of sales taxes, which are used primarily at the state and local level is 26.2 cents per dollar of revenue, while the cost of property taxes, also employed mainly at the state and local level is 17.6 cents per dollar of revenue. The efficiency losses were 49.7 cents per dollar of income tax revenue, only 17.6 cents per dollar of property tax revenue, and only 26.2 cents per dollar of sales tax revenue. A substantial increase in efficiency could be realized by reducing income tax rates and increasing the rates of sales and property taxes. We conclude that the Tax Reform Act of 1986 did not successfully overcome the excessive reliance of the U.S. tax system on income taxes.

An important priority for future budgetary policy is to lessen the dependence of the U.S. tax system on income taxes. Since the federal government relies heavily on income taxes as a revenue source while state and local governments raise a substantial proportion of their revenues from sales and property taxes, the way to achieve this is to shift tax burdens from the federal government to state and local governments. Two tax measures that go in this direction are the elimination of tax deductibility of all state and local taxes, including property taxes, and elimination of tax exemptions for all interest on securities issued by state and local governments. Reversing the direction of the 1986 reform by raising marginal rates for "high income" taxpayers has greatly increased the tax burden on capital income. This will be enormously costly in terms of opportunities for reviving the disappointing growth of the U.S. economy.

4. Summary and Conclusion.

My overall conclusion is that capital budgeting is a very wortwhile proposal that deserves serious consideration by the Congress and the Administration. Although the introduction of a capital budget would require a dramatic change in the formulation of federal budgetary policy, the information required to implement such a budget could be generated. However, assembling this information and interpreting it as part of the budgetary process is a very sizeable undertaking. Like any major change in the process of enacting the federal budget, capital budgeting would impose a major burden on the Administration and the Congress, especially on the principal budgetary agencies, OMB and CBO, and the Congressional committees involved in budgeting and appropriations.

The point of departure for capital budgeting by the federal government should be a federal balance sheet, like the one compiled by the Board of Governors of the Federal Reserve System. Items in the current federal budget appropriate for treatment as capital expenditures could be identified as those that result in additions to federal assets or reductions in federal liabilities. It is somewhat disturbing that capital budgeting has been approached by OMB in its Special Analyses as a kind of addendum to the federal income statement, providing information on current and capital expenditures, but failing to integrate this information with a federal balance sheet.

I have illustrated the balance sheet approach to capital budgeting by the example of investment in human capital, treated as an government investment by OMB. By considering the balance sheet treatment of human capital we find that government outlays on human capital at both federal and state and local levels result in the accumulation of assets by the private sector, specifically, the households that experience increments in lifetime labor incomes. Government outlays on human capital are analogous to subsidies on private investment. The balance sheets of federal and state and local governments that provide financing for schools and educational institutions do not and should not include entries corresponding to these investments.

Capital budgeting is not a panacea for the seemingly intractable problems of restoring fiscal discipline to the federal government. Financing of government expenditures through tax policy, whether these expenditures are on current or capital account, imposes hidden costs on the U.S. economy that are very substantial. This is a central issue in budgetary policy, since the financing of government expenditures can be enormously costly. These costs are well known to economists and have been quantified successfully. However, hidden costs of taxation have not figured in discussions of budgetary policy and would not be required by capital budgeting.

For example, government revenues generated by taxes on capital income at the individual level cost more than one dollar of loss in growth opportunities for the economy for every dollar of government revenue raised. Since the Clinton Budget Plan relies very heavily on the taxation of capital income at this level, this legislation will nullify many of the growth opportunities for the U.S. economy created by the Tax Reform Act of 1986. It is important to underline this conclusion, since the Clinton Budget Plan's emphasis on "soaking the rich" increases reliance on capital incomes taxes relative to those on labor income. This will sacrifice substantial future opportunities for growth of the U.S. economy.

By quantifying the economic impact of the tax system, economists can help budget policy makers focus on the consequences of tax policy changes for opportunities to restore the growth of the U.S. economy. As these consequences are better understood by both economists and policy makers, one can even visualize the day when every component of the U.S. tax system – every tax, every deduction, and every credit – will have its own number, signalling the creation of future growth opportunities at the margin where the last tax dollar is raised. This information must play a central role in the restoration of a sound budget policy at the federal level.

References

Jorgenson, Dale W., and Barbara M. Fraumeni, "The Accumulation of Human and Nonhuman Capital, 1948-84," in Robert E. Lipsey and Helen Stone Tice, eds. *The Measurement of Saving, Investment, and Wealth*, Chicago, University of Chicago Press, 1989, pp. 227-282.

Jorgenson, Dale W., and Kun-Young Yun, "The Excess Burden of U.S. Taxation," *Journal of Accounting, Auditing, and Finance*, Vol. 6, No. 4, Fall 1991, pp. 487-509.

Mr. CONYERS [presiding]. Thank you for your comments, Dr. Jorgenson. I apologize for coming in in the middle of your presentation and for missing Dr. Eisner; but I want to underscore our deep interest and concern with the subject of capital budgeting and the related issues that are involved. They are quite fascinating to me, and I am looking forward to an opportunity where all three of us will be able to discuss this matter in a more informal setting. I am very interested to know what your relationship with Leon Panetta and other officials in the government who are deeply concerned about this subject matter as well. I think, in that way, we will begin to develop a framework for understanding the possibilities, the variations and the opportunities that are involved.

I am very delighted to have all of our witnesses here today.

However, we have been called to the floor for a vote. So, Dr. Aschauer, we will ask you to hold off until we come back.

Dr. ASCHAUER. I understand.

[Recess taken.]

Mr. PETERSON [presiding]. The subcommittee will come back to order.

Our next witness is David Aschauer, professor of economics at Bates College in Lewiston, ME. Dr. Aschauer enjoys a distinguished academic career, serving on the graduate faculties of the University of Michigan and the University of Chicago, as well as serving as a visiting scholar at the Institute of Fiscal and Monetary Policy Studies at the Japanese Ministry of Finance. He has also served as senior economist at the Federal Reserve Bank of Chicago.

STATEMENT OF DAVID A. ASCHAUER, PROFESSOR OF ECONOMICS, BATES COLLEGE

Dr. ASCHAUER. Thank you, Mr. Peterson. It is an honor to be here. It is also an honor to be on the panel with my esteemed colleagues.

In recent months, the guiding principle in the budgetary process has been deficit reduction. I applaud the Congress and administration in achieving significant deficit reduction through 1998. Despite the fact that OBRA 93 will not put us on a sustainable fiscal policy path, with the Federal debt-to-GNP ratio rising throughout the 1990's and into the next century, it can be expected our long-term economic growth prospects will be somewhat improved as a result of OBRA 93.

I would argue deficit reduction can be too much of a good thing. The fundamental principle which should guide Federal budgetary deliberations is not the size of the deficit, no matter how we define it, the size of the debt, nor the interest burden on the debt. Rather the fundamental focus should be on the separate impacts of government spending and taxes on the economy and society.

For example, I agree in principle with President Clinton's statement in Vision of Change that: ". . . like private investments, well-selected public investments raise future living standards. Deficit reduction at the expense of public investment has been and will continue to be self-defeating. One without the other will not work."

Of course, the idea here is if we are concerned about long-term economic growth and our living standards, we should be concerned with national investment and not necessarily with private or public

investment alone. Deficit reduction can indirectly raise national investment by lowering interest rates and stimulating private investment. But public investment will directly lift national investment. So if it were the case that, on the margin, public and private investments offer about the same return, deficit reduction, at the expense of public investment, will offer no gain to national investment nor to economic growth and living standards. It will appear that by reducing the deficit, Congress and the President will have done the Nation a valuable service. But it will only be an illusion. Indeed, it is quite conceivable that the Congress and the administration would have done the Nation a disfavor for a couple of reasons.

First, there is evidence that public investments in infrastructure, in education, and in scientific research can offer higher returns than the average private investment in business, plant, and equipment. There is some evidence that public investment in these categories even yields higher returns, substantially higher returns; although the range of estimate is quite substantial.

At least in the press, Dale Jorgenson and I have been involved in a debate on the size of some of these estimated returns. I used to worry about the credibility of my estimates. I have seen, as of Sunday, I believe, an estimate of the potential job losses from NAFTA, 85 million, if you were to go back and listen to what Ross Perot had to say on Sunday.

Anyway, even if national investment were to remain unchanged as a result of deficit reduction, it is certainly possible the overall productive impact of that investment will have been reduced.

We keep the national investment unchanged; but because we are changing the composition of national investment away from relatively more productive items, the productive impact of that investment is reduced.

Second, deficit reduction financed by cutting public investment may actually lower national investment. There is some evidence that lower deficits have only a minor effect on interest rates, and there is also evidence that lower interest rates have only a minor effect on private investment. Again, the range of empirical results is broad, but it is conceivable that a $100 billion reduction in the budget deficit, accomplished through a $100 billion reduction in productive public investments, will raise private investment by somewhat less than $100 billion. The result would be that national investment would be lower.

I am not trying to argue that cutting public investment for the purpose of deficit reduction will necessarily dampen productivity growth. While that is a believable outcome, I am merely trying to make the point that in the making of fiscal policy it is important to distinguish between public investment and public consumption. Having recognized this point, the argument can be made that a separate capital budget is useful since the absence of such a budget obscures the distinction between public capital expenditure and public consumption and, in so doing, may lead to inadequate public investment.

I agree with President Clinton's overall statement, I believe it is not adequate enough to provide an appropriate budgetary framework. For one thing, his statement implies that public investment

and productive government spending are one and the same thing. Of course, this is obviously false.

Public investment spending can be unproductive, and public consumption spending can be productive. For example, the salaries paid to government workers are clearly a component of government consumption and yet may well be a productive form of expenditure—at least for essential workers who have to come in on snow days.

For another thing, his statement suggests that economic growth and the standard of living, or growth in the standard of living, are one and the same. This, too, is wrong. For instance, a greatly expanded national park system may raise our standard of living without having any direct impact on economic growth.

Now, the usual concern with the establishment of a capital budget is that all sorts of things will be called investments—"investments"—will be included in a capital budget, and generate a sizable increase in the budget deficit. While that is a concern, it is not the concern I wish to bring out today. Instead, I am worried that a capital budget will limit the amount of government spending in areas which have a productive impact on the economy.

Bear with me for this argument.

Suppose, for example, that the consolidated budget is separated into a capital budget and an operating budget. The operating budget must be balanced. Finally, suppose we know that government consumption—spending of a certain type—not investment, but consumption—is below its optimal level.

In this environment, an increase in this form of government spending—financed through higher taxes, say, so it is consistent with budget balance—will increase the long-run level of output in the economy. This is good for the economy. It will be raising output in the long run. What can we expect to happen over time?

Since the government policy in increasing government spending has improved the functioning of the economy, we can expect the returns to private investment will be higher than before. As a result of that, investment will rise, and economic growth will be stimulated.

Ultimately, the level of output and capital stock will converge to a long run, higher level.

What is important in seeing that argument is that, during a portion of this transition period to the long run, consumption will be lower than previously. We are getting there by increasing investment. So, for a time, people will feel and actually be worse off. This period of time could well be a long time. Empirical estimates of how long it takes for the economy to go from one long-run equilibrium to another, are in the range of longer than 30 years. It gets into half lives and things like that. It could be a very long time.

How can this blow be softened? One way would be if tax rates were kept relatively low in these early years, lower than the level needed to cover the increased government spending. This, however, entails that the government run a deficit in the early years. The fundamental point is that from a long-run perspective, deficit financing can be justified just as easily for an increase in public consumption as for an increase in public investment.

This, in turn, means that it would be just as reasonable—and on conceptual grounds, I would push this—just as reasonable to have separate budgets for productive and unproductive spending—allowing deficit finance for, at least some, of the former for, at least part, of the time it takes the economy to absorb the increase in spending as it would be to have separate budgets for public investment and public consumption.

I am saying it is important not to just look at the intertemporel nature of the timing of the benefits but whether they will be increasing the long-run level of output and, by that, economic growth.

As I say, it would be difficult to implement such a budget framework. It would be necessary to know rather precisely the degree to which various types of government spending impact on the productive potential of the economy in the short run, the long run, and even during the transition period.

So I am not advocating, necessarily, the adoption of this type of framework.

Thinking along these lines makes me suspicious that a capital budget such as that suggested by Vice President Gore in his National Performance Review with a capital budget for fixed Federal assets will be particularly advantageous from the perspective of our long-run economic welfare.

The important consideration is that we adequately fund those programs which will raise our long-run standard of living to its highest level and that we finance those programs in a manner which places a roughly equal burden on all generations.

Thank you.

[The prepared statement of Dr. Aschauer follows:]

Statement on Capital Budgeting

Committee on Government Operations
Legislation and National Security Subcommittee
U.S. House of Representatives
November 9, 1993

David Alan Aschauer
Elmer W. Campbell Professor of Economics
Bates College
Lewiston, ME 04240

In recent months, the guiding principle in the budgetary process has been deficit reduction. I applaud the Congress and President Clinton in achieving significant deficit reduction. Despite the fact that OBRA93 will not put us on a sustainable fiscal policy path--with the federal debt continuing to grow at a faster pace than the economy in every year into the foreseeable future--it can be expected that our long-term economic growth prospects will be improved as the result of OBRA93.

Yet I argue that deficit reduction can be too much of a good thing. The fundamental principle which should guide federal budgetary deliberations is not the size of the deficit (no matter how you define it), the size of the debt, or the interest burden of the debt. Rather, the fundamental focus should be on the separate impacts of government spending and taxes on the economy and society.

For example, I agree in principle with President Clinton's statement in Vision of Change that

> ...like private investments, well-selected public investments raise future living standards. Deficit reduction at the expense of public investment has been and will continue to be self-defeating. One without the other will not work.[1]

The idea is that if we are concerned about long term economic growth and future living standards, we should be concerned with boosting national investment. Deficit reduction can indirectly raise national investment by lowering interest rates and stimulating private investment. But public investment will directly lift national investment.[2] So if, on the margin, public and private investments offer similar economic returns, then deficit reduction at the expense of public investment will offer

---

[1] A Vision of Change for America, page 10.

[2] This assumes that public and private capital are not perfect substitutes for one another. See D. Aschauer "Does Public Capital Crowd Out Private Capital," Journal of Monetary Economics, October 1989.

no gain to national investment nor to economic growth and living standards. It will appear that by reducing the deficit, Congress and the President will have done the nation a valuable service. But it will only be an illusion. Indeed, it is quite conceivable that the Congress and the Administration would have done the nation a disfavor for a couple of reasons.

> First, public investments in infrastructure, in education, and in scientific research might offer higher returns than the typical private investment. There is some evidence that public investment in these categories does, indeed, yield higher returns than private investment in plant and equipment, although the range of estimates is quite substantial.[3] So, even if national investment were to remain unchanged as a result of deficit reduction, it is certainly possible that the overall productive impact of that investment will have been reduced.
>
> Second, deficit reduction financed by cutting public investment may actually lower national investment. There is some evidence that lower deficits have only a minor effect on interest rates, and there is also evidence that lower interest rates have only a minor effect on private investment.[4] Again, the range of empirical results is broad, but it is conceivable that a $100 billion reduction in the budget deficit, accomplished through a $100 billion reduction in productive public investments, will raise private investment by somewhat less than $100 billion. The unintended consequence would be a decline in our national investment rate.

I am not trying to argue that cutting public investment for the purpose of deficit reduction will necessarily dampen productivity growth. While that is a believable outcome, I am merely trying to make the point that in the making of fiscal policy it is important to distinguish between public investment and public consumption. Having recognized this point, the argument can be made that a separate capital budget is useful since the absence of such a budget obscures the distinction between

---

[3]For example, see: D. Aschauer, "Genuine Economic Returns to Infrastructure Investment," Policy Studies Journal, Summer 1993 for a discussion of the returns to infrastructure; J. Pencovel, "Higher Education, Productivity, and Earnings," Journal of Economic Education, Fall 1991 for a discussion of the returns to education; and M. Nadiri and T. Mamuneas, "The Effects of Public Infrastructure and R&D Capital on the Cost Structure and Performance of U.S. Manufacturing Industries," National Bureau of Economic Research Working Paper No. 3887 for a discussion of the returns to research and development.

[4]For example, see: R. Barro, "The Ricardian Approach to Budget Deficits," Journal of Economic Perspectives, Spring 1989 for a discussion of the effects of budget deficits on interest rates; S. Fazzari, "The Investment-Finance Link," Jerome Levy Economics Institute Public Policy Brief No. 9/1993 for a discussion of the effects of interest rates on investment.

public capital expenditure and public consumption and, in so doing, may lead to inadequate public investment and economic growth.

While I agree with President Clinton's overall statement, I believe that it is not accurate enough to provide an appropriate budgetary framework. For one thing, his statement implies that public investment and productive government spending are one and the same. Of course, this is obviously false. Public investment spending can be unproductive, and public consumption spending can be productive. For example, the salaries paid to government workers are clearly a component of government consumption and yet may well be a productive form of expenditure (at least for essential workers). For another thing, his statement suggests that economic growth and the standard of living (or growth in the standard of living) are one and the same. This, too, is wrong. For instance, a greatly expanded national park system may raise our standard of living without having any direct impact on economic growth.

The usual concern with the establishment of a capital budget is that all sorts of things will be called investments, included in a capital budget, and generate a sizable increase in the budget deficit. While that is a concern, it is not the concern I wish to bring out today. Instead, I am worried that a capital budget will limit the amount of government spending in areas which have a productive impact on the economy.

Suppose, for example, that the consolidated budget is separated into a capital budget and an operating budget. The operating budget must be balanced. Finally, assume that we know that government consumption is below its optimal level.[5]

In this environment, an increase in this form of government spending--financed through higher taxes--will increase the long run (or what economists call the *steady state)* level of output Now, what can we expect to happen *over time*? Since the government policy of increasing government spending has improved the functioning of the economy, we can expect that the return to private capital (or, loosely speaking, the profit rate on business plant and equipment) will rise. This will stimulate private investment spending and, over a period of time, cause the private capital stock and total output to gradually rise--ultimately converging to correspondingly higher, steady state levels.

But what is important to see is that during a portion of the transition period, consumption will be lower than it was previously, so that for a time people will feel and actually be worse off. This period of time could well be a long time, most

[5]In technical terms, the initial level of government spending is such that the marginal product of government spending is greater than unity. In this situation, an increase in public spending will raise steady state output by more than the extra government spending, and there will more net resources available to the private sector. See M. Baxter and R. King, "Fiscal Policy in Generni Equilibrium," American Economic Review, June 1993.

certainly longer than four years. Empirical estimates indicate that it takes a long time for the economy to move from one to another steady state equilibrium--perhaps longer than 30 years.

How can this blow be softened? One way would be if tax rates were kept relatively low in these early years, lower than the level needed to cover the increased government spending.[6] This, however, entails that the government run a deficit on the operating budget, which would not be allowed under the postulated budgetary framework. The fundamental point is that from a long run perspective, deficit financing can be justified just as easily for an increase in public *consumption* as for an increase in public *investment*.

This, in turn, means that it would be just as reasonable to have separate budgets for productive and unproductive spending--allowing deficit finance for (at least some) of the former for (at least part) of the time it takes the economy to absorb the increase in spending--as it would be to have separate budgets for public investment and public consumption.

Of course, it would be difficult to implement such a budget framework. It would be necessary to know, rather precisely, the degree to which various types of government spending impact on the productive potential of the economy in the short run, the long run, and during the transition period. So I am not advocating the adoption of this type of framework.

Nevertheless, thinking along these lines makes me suspicious that a capital budget such as that suggested by Vice President Gore's National Performance Review--with a capital budget for fixed federal assets--will be particularly advantageous from the perspective of our long run economic welfare. The important consideration is that we adequately fund those programs which will raise our long run standard of living to its highest level, and that we finance those programs in a manner which places a roughly equal burden on all generations.

Thank you for your attention, and I welcome any questions you may have for me.

---

[6]For this type of analysis, see D. Aschauer and J. Greenwood, "Macroeconomic Effects of Fiscal Policy," in K. Brunner and A. Meltzer, eds., The "New Monetary Economics," Fiscal Issues and Unemployment, Carnegie-Rochester Conference Series on Public Policy, Autumn 1985.

Mr. PETERSON. Thank you, Dr. Aschauer, for that testimony. We appreciate your being with us.

We certainly appreciate the panel's time. However, due to the time constraints we are under, the committee will decline to ask questions at this time and, instead, submit questions to you for the record.

Dr. ASCHAUER. I will be happy to answer them.

Mr. CONYERS. May I just ask one? I hope this will not be the exception that destroys our attempt to get through here quickly, Chairman Peterson.

Within this capital budgeting discussion is this larger nagging question of how we create jobs and reinvigorate our economy. So it seems to me the concept of including a human potential into this accounting discussion has possibilities in terms of congressional efforts to look, analyze, and evaluate what we have to do to create, as nearly as we can, a full employment society.

Would any of you like to just comment on this notion?

Dr. EISNER. Yes. I think it is very important in that regard. That is the critical issue. Unfortunately, we have been paralyzed in a lot of those efforts by our, I would say, phobia, about a mismeasured budget deficit.

We should account for the budget in such a way that we can see what is going on. The main argument for reducing the deficit has been that we have to somehow free resources for private investment by not having the government borrow as much. That is a dubious argument, as I keep insisting, to begin with, because it is not at all clear that if you cut the deficit by cutting government spending or jobs or by taking away people's income or purchasing power—it is not at all clear that if we do not buy a car because our taxes are higher, that Chrysler or General Motors will invest more.

That phobia of contributing to the future of national saving by reducing the deficit has paralyzed efforts to create jobs. Any program for stimulus, any program for job training keeps running into this argument: We cannot do it because of the deficit, and we cannot do it because of the deficit because that is hurting the future.

Mr. CONYERS. As occurred during consideration of the President's stimulus package earlier this year?

Dr. EISNER. That is right. If we account for things properly, then, just as any private business would do, we can free ourselves of a good bit of that difficulty. We can recognize, as both of my colleagues are pointing out, this critical issue of what we are providing for the future; and you can recognize that many of the things you would want to do to create jobs now, to provide for the present, may provide for the future as well.

But that, then, should be a critical focus; and I think it is inexcusable, aside from how you use this, that the Federal Government simply has a set of accounts and does not, on the surface, inform people as to the basic information you would need.

If any private business presented accounts like this, I think, Professor Jorgenson pointed out, the people would be aghast. The accountant would be thrown out. You have to have a picture of your current spending as against investment spending. You may decide you want more or less investment spending after you know about

it. Professor Aschauer has pointed out that there may well be current expenditures that you want to make; but you have to know what they are.

You know, I have heard arguments—I hate to say from respectable figures, including—well, I will name names—Alice Rivlin and I argued about it. She doesn't want to have a capital budget. She thinks that will give people the excuse to spend too much. For God's sake let's know where we are. Then I trust Congress will make the decision whether to spend it on investment or something else.

Don't say we will give the public misleading figures because that will help us in our case to do whatever we want to do.

Dr. JORGENSON. I would like to signify my agreement with the basic thrust of your question, Mr. Chairman. I think the investment in human capital is the only solution to the problems of long-term unemployment.

Long-term unemployment, obviously is not the top issue in our Nation. There are 3 million people who are, at the moment, counted as long-term unemployed. But that is something that has crept up over the last few years and is clearly growing.

If you look at the circumstances, not only of the people listed as long-term unemployed but those people who would like to become involved in the labor force, who currently are not now involved in the labor force, there is no doubt that we are underinvesting in the human capital that those individuals possess.

If you look at our competitors, despite the fact that I think it is easy to overestimate the achievements of the Europeans and the Asians and so on with whom we compete in the world market, the fact is they do a better job with the most important part of that investment portfolio, which is the 50 percent of our population that never goes to college.

That is where the investment would really pay off. That is entirely separate from the issue of creating jobs through a stimulus package. We are talking about investment programs.

Now if we asked the question: Where do those investments occur? The answer is that, by and large, those are investments that take place at the State and local level. The Federal Government has a limited role to play. One of the central features of Alice Rivlin's proposal, to which Professor Eisner just alluded, is the idea we ought to be strengthening the role of these State and local governments, we ought to be transferring functions and resources to the State and local governments so that they can properly manage that very, very important part of the investment portfolio.

That is why it is so important to concentrate on the fact that, at the current moment, the high cost sources of revenue for the government sector are those that are available to the Federal Government. The Federal Government uses income taxes.

That was the core of the Clinton budget plan just enacted by the Congress and signed into law by the President. That used the highest cost form of government revenue to deal with the budgetary issues which the Congress and the administration were trying to address.

In order to reduce the costs of making these investments in human capital, we need to transfer the revenue sources and the re-

sponsibility to the State and local governments. That is the thrust of Alice Rivlin's basic budget taxpayer plan that is now available in paperback. I am happy to say it is not expensive to find out about that plan. You can call Brookings and get a copy of her proposals. That is a very sound proposal. I am fully supportive and fully supportive of your thought this kind of investment is a central responsibility of the government, it is the central responsibility primarily of State and local governments.

As you know, in your own State, this is a matter that is currently being debated very actively. I am sure the Nation will be watching.

Mr. CONYERS. Dr. Jorgenson, before you leave the podium, let me just throw these factors into the discussion.

First of all, 3 million unemployed mask the deeper problem of 6.8 percent unemployed which further masks a deeper problem of metropolitan urban unemployment which can climb to 50, 60 percent in some tracts in the city of Detroit or in any major city.

As a second point, I would point out the economic destabilization and the decay of the urban infrastructure have grown so profound that in our urban areas now, after 12 years of benign neglect, we are reaping the whirlwind. It is becoming quite clear that this is a very large problem.

The final factor is that our cities and States are all busted. It is a wonderful nation to thrust responsibility on them, except I happen to know that more of them are going broke or near bankrupt as we speak. I hate to refer to political cartoons of former President Ronald Reagan who said, spend high, tax low, blame the incoming administration and then say, there they go again, tax and spend, tax and spend, tax and spend. That is sort of a political mantra that gets you through any intellectual discourse in this business.

Dr. JORGENSON. Well, I certainly agree with you that the areas you have identified are the areas where the investments I was talking about, the investments in human capital would be most productive. That is exactly where we ought to be focusing our attention.

The question is whether capital budgeting, which is the subject of this hearing, is the solution to that problem.

My conclusion is that it is a solution only in a very indirect sense. I think if you carry through the steps that I tried to outline in my analysis, you find that an attempt to deal with that range of issues, which I—about which I share your concern and also share your sense of priorities, that is where the payoff is; that is where the investments can be the most productive.

But to view capital budgeting at the Federal level as the complete answer overlooks the considerations I described. When you carry through the program, focusing on what capital investment is, using the analogy Professor Eisner suggested with business investment, you quickly end up with the idea of a balance sheet on which you focus on items that will slow up on the Federal Government's balance sheet.

The investments we were talking about in the urban youth or urban areas, more generally, through formal schooling, through training programs, through remedial education, through whatever it takes to bring people's educational qualifications up to the needs

of our current labor force and international competition, all of those things are going to be addressed only very, very indirectly by the Federal Government.

So the question that we have to face is: How can we provide these resources that are needed by the State and local governments to meet their responsibilities? How can the Federal Government play a role?

My conclusion would be that the Federal budgetary process is, at most, a very, very indirect revenue, despite the fact that capital investment in specifically investment in human capital is the high payoff investment for our society for the reasons you indicated.

Dr. ASCHAUER. I agree with the statements made about the return to human capital. It should be a high priority investment with respect to budgetary considerations.

I think you are right on line if you are thinking if there is a crisis. It is a crisis that should be seen somewhere beyond a rising debt-to-GNP ratio or GDP ratio. That is an important consideration. But what we need to be concerned with is the types of government spending we are doing to make sure we are adequately funding government spending which can yield positive and high returns.

I would say, though, that coupling investments in human capital or infrastructure or in science with the idea of job creation in the short run is probably counterproductive. I am not that good an observer of what is going on in Washington in terms of the politics; but it is my suspicion that by linking job creation and investments, you took away some of the power of—the distinction between investment and consumption spending or productive and unproductive spending since, if all your goal is to create jobs in the short run, then any government spending does that.

That should then be determined on which has the biggest impacts through input-output tables and not from which is best from the perspective of the long-run growth of the economy.

Mr. PETERSON. We want to thank the panel. As I said, we have questions we will be submitting for the record. We will hold the record open for your responses. We appreciate you accommodating us.

Thank you very much.

I would like to proceed and call the second panel, Dr. Letitia Chambers and Paul Posner, Director of Budget Studies of the General Accounting Office, both who have very distinguished backgrounds. Dr. Chambers is the former staff director of the Senate Labor and Human Resources Committee, as well as a former senior staff member of the Senate Budget Committee. Following last year's Presidential election, Dr. Chambers served as chief budget advisor of the Clinton/Gore transition team. Along with Jim Rotherham, a former House Budget Committee senior staff member, Dr. Chambers has developed a potential capital budget structure, which we will be reviewing today.

STATEMENT OF LETITIA CHAMBERS, PRESIDENT, CHAMBERS ASSOCIATES, INC.

Ms. CHAMBERS. Given the time constraints, I will summarize my remarks. I would like to say at the outset that it is a privilege to

be here today to talk about a subject of crucial importance to getting our fiscal house in order.

I would also like to say that my remarks are made as an individual and do not reflect the views of my firm or any client of the firm.

Some of my testimony is taken from a paper that I coauthored with Dr. James A. Rotherham, who is here today and who also assisted with the development of my testimony. That paper has been made available to the committee staff. I have additional copies if you would like to have it. That paper and a portion of my written testimony goes into great detail in identifying what programs should be put in a capital budget and also recommends the establishment of some other changes in budget structure.

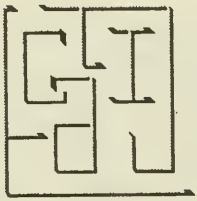
Mr. PETERSON. We will include that as part of the record.

[The information follows:]

RESTRUCTURING THE FEDERAL BUDGET

Letitia Chambers and
James A. Rotherham

April, 1993



Chambers Associates, Incorporated
1625 K Street, N.W.
Suite 200
Washington, DC 20006
(202) 857-0670

Restructuring the Federal Budget

TABLE OF CONTENTS

SECT. I THE CURRENT FEDERAL BUDGET STRUCTURE DISTORTS PUBLIC DEBATE ABOUT THE DEFICIT 1

The Current Budget Understates the Deficit 1

Sources of the Deficit 3

Entitlements 3

Discretionary 6

What Besides Health Care Costs Caused The Increase in the Deficit? 7

Budgetary Focus on Deficits Undermining Capital Investment and Economic Growth 8

Short-Term Focus and Inadequate Accounting System 10

Need for a Capital Budget 11

Income Replacement Budget 13

Overview of a Restructured Budget 17

SECT. II CAPITAL INVESTMENT BUDGET 18

Physical Capital Investment - Defense Related 21

Physical Capital Investment - Civilian 22

Research and Development (R&D) Investment 25

Human Capital Investment 28

Other Human Capital Investment 31

Direct and Guaranteed Loans 31

SECT. III INCOME REPLACEMENT BUDGET 38

Unified Budget Understates Operating and Interest Expense 39

Accounting Treatment Trust Funds in the Income Replacement Budget 41

Budget Estimates for Income Replacement Budget 42

SECTION I. THE CURRENT FEDERAL BUDGET STRUCTURE DISTORTS PUBLIC DEBATE ABOUT THE DEFICIT

The last time the Federal budget showed a surplus was Fiscal Year 1969. Ironically, that same year the Johnson administration instituted the current unified budget structure, which had been developed by the 1967 President's Commission on Budget Concepts. Over the past 24 years during which the unified budget has been in effect, the United States has had the longest period of sustained budget deficits in its history. Over this period, the unified budget structure has become an increasingly poor measure of the deficit and grown increasingly irrelevant to a serious debate about the role of the Federal government in the economy.

Also under the unified budget, when the Federal government makes a capital investment in infrastructure, the total cost is expensed when the checks are written. Every dollar spent adds to the reported deficit. In contrast, in the private sector, only the depreciation on investments is charged as a current expense, and in many state budgets, infrastructure investments are separated into a separate capital budget. This Federal accounting technique treats capital investments as if they were current consumption rather than an investment in future growth and productivity, which places infrastructure investment as a disadvantage in competing for budgetary resources with consumption programs.

The Current Budget Understates the Deficit

The current budget structure understates the extent to which general revenues fail to cover the cost of government. The treatment of interest in the budget is an example of how distorted the presentation of the budget has become in recent years. The unified budget excludes from the budget totals interest paid to trust funds and never gives a clear presentation of the percentage of general revenues devoted to financing interest charges. In the President's Fiscal Year 1993 budget, $101 billion in interest paid to trust funds are excluded from the interest function and from budget outlay totals. The total interest obligation of the Federal government in FY 1993, including interest owed to trust funds, will be $315 billion. This equals 45.5 percent

of general revenue, which is estimated at $693 billion for Fiscal Year 1993 [1] Nearly one out of every two dollars in general revenues collected by the Federal government in Fiscal Year 1993 will go to pay interest on the national debt.

The current budget structure is no longer relevant to the issues which the United States faces as the 20th century draws to a close, and in fact, the budget structure itself has become a hindrance to sound fiscal policy making.

Under the unified budget concept, all revenues are arrayed on one side of the ledger, and all spending is arrayed on the other side. All revenues earmarked by statute to support a specific activity are pooled with general revenues, and all spending is also pooled, regardless of its revenue source. The difference between total revenue and total spending determines whether the budget is in balance, surplus, or deficit. Thus, under the unified budget the current surplus in the trust fund component of the budget masks part of the deficit in the general fund component of the budget, as shown in Table IA.

---

[1] Unless indicated otherwise, all estimates are based on the budget submitted by President George Bush in February 1992. The budget material released by the outgoing and incoming Administrations during January and February 1993 did not contain enough detail to develop the budget allocations presented later in this article.

The breakdown of general revenue is as follows:

President's Budget Fiscal Year 1993 General Revenue (In billions of dollars)	
Individual Income Tax	515.2
Corporate Income Tax	103.8
Excise Taxes Not Tied to Trust Funds	22.3
Other	51.6
Total General Revenue	692.9

3

Table IA Surplus or Deficit by Fund Group Fiscal Year 1993 President's Budget (in billions of dollars)	
Surplus (+) / Deficit (-)	
General Funds	-468.9
Trust Funds	+119.0
Consolidated Deficit	-349.9
Source: OMB, The Budget For Fiscal Year 1993: Supplement (February 1992), Part 3, Table 1.4, p. 19.	

Trust funds are financed with revenues that can only be used for specific dedicated purposes. The overall surpluses in dedicated funds, which will total $119 billion in FY 1993, will increase dramatically over the rest of the decade. During the 1980's, the government moved from a pay-as-you-go policy for retirement trust funds to a strategy to build up balances in the trust funds, particularly the cash benefit Social Security funds and the Federal employee retirement and disability funds. Now for the retirement benefits of about two thirds of Federal employees, the Federal government fully accrues each year their future pension costs, in much the same manner as private employers fund employee pensions.

The balances held by U.S. government trust funds must by law be invested in U.S. government securities. OMB estimates that by the end of 1997, these trust fund balances will total $1.7 trillion compared with actual balances of $0.9 trillion at the end of 1991. To the extent that trust fund balances finance deficits in Federal programs which are supposed to be paid for with general revenues, the trust fund assets are not being invested to finance the future obligations they represent. Ultimately, trust fund balances are IOU's on the future productive capacity of the U.S. economy. To the extent that these assets are used to finance current government consumption, resources are not available to expand the productive capacity of the economy, and thus reduce the economic burden when these trust fund IOU's are redeemed.

Sources of the Deficit

The unified budget presentation not only hides the true scope of the deficit, but also skews the debate about the sources of the deficit. A useful way to analyze

4

Federal spending, revenue, and the deficit is as a percentage of Gross Domestic Product (GDP). This approach allows inter-temporal comparisons of the relative burden of government taxation and spending. This section analyzes the sources of the increase in the deficit by comparing fiscal years 1980 and 1992. Over this 12-year period, the deficit as a percentage of GDP increased by 2.1 percentage points from 2.8 to 4.9 percent of GDP.

Entitlements -- It has become almost trite to assert that entitlement spending is out of control. The unified budget structure gives credence to that assertion because all spending is lumped together, regardless of how the spending is financed.

In fact, only one area of entitlement spending is out-of-control -- health care. Between 1980 and 1992, Medicare and Medicaid spending increased from 1.8 to 3.4 percent of GDP, an increase of 1.6 percentage points. Driving the rise in the health entitlement costs is inflation in the entire health care sector, not factors unique to Medicare and Medicaid.

Other entitlement programs are not out of control. Although spending for the largest entitlement, Social Security, increased by 0.5 percentage point over this 12-year period, the program in fact reduced the deficit because Social Security tax revenue increased by 0.9 percent of GDP. No other single entitlement program increased by more than 0.1 percentage points of GDP over this 12-year period. In the aggregate, the entitlements other than Medicare, Medicaid and Social Security declined from 9.2 percent of GDP in 1980 to 8.7 percent in 1992, or a 0.5 percentage point decline.

Table IB arrays entitlement spending as a percentage of Gross Domestic Product (GDP) in nominal dollars and as a percentage of total Federal spending.

Table 18
Entitlements and Other Mandatory Spending
As A Percentage of Gross Domestic Product (GDP)
Fiscal Years 1980 and 1992

	Fiscal Year 1980	Fiscal Year 1992	Fiscal Year 1992 minus Fiscal Year 1980
Medicare and Medicaid	1.8%	3.4%	1.6%
Social Security	4.4%	4.9%	0.5%
Low-Income (Excluding Medicaid and Unemployment Compensation)[2]	1.2%	1.3%	0.1%
Unemployment Compensation	0.6%	0.6%	0.0%
Agriculture	0.1%	0.2%	0.1%
Retirement Other Than Social Security	1.2%	1.1%	-0.1%
Other	1.7%	0.6%	-1.1%
Total	11.0%	12.1%	1.1%
Total Entitlement and Mandatory Outlays (in billions of dollars)	$292B	$711B	
Percentage of Total Federal Spending	49.3%	51.5%	
Total Entitlement and Mandatory Outlays Excluding Medicare and Medicaid (in billions of dollars)	$244B	$514B	
Percentage of GDP	9.2%	8.7%	
Percentage of Total Federal Spending	41.2%	37.2%	

Source: Congressional Budget Office (CBO), The Economic and Budget Outlook: Fiscal Years 1994-1998 (January 1993), Tables E-3 and E-11.

[2] Major low-income programs include: Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), Food Stamps, Child Nutrition, Refundable portion of Earned Income Tax Credit, and Veterans Pensions.

6

Discretionary -- Table IC shows that discretionary spending also declined as a percentage of GDP, from 10.5 in 1980 to 9.2 percent in 1992.

Table IC Discretionary Spending As A Percentage of Gross Domestic Product (GDP) Fiscal Years 1980 and 1992	
Domestic	-1.2
Defense	+0.1
International	-0.2
Total	-1.3
Source: CBO, The Economic and Budget Outlook: Fiscal Years 1994-1998 (January 1993), Table E-9.	

Within the overall decline, domestic discretionary had the most sustained contraction over this 12-year period. Its share of GDP declined by 1.2 percentage points. Defense increased by only 0.1 percentage point. International declined by 0.2 percentage points.

Figure I shows the trends for these three categories over the 12-year period.

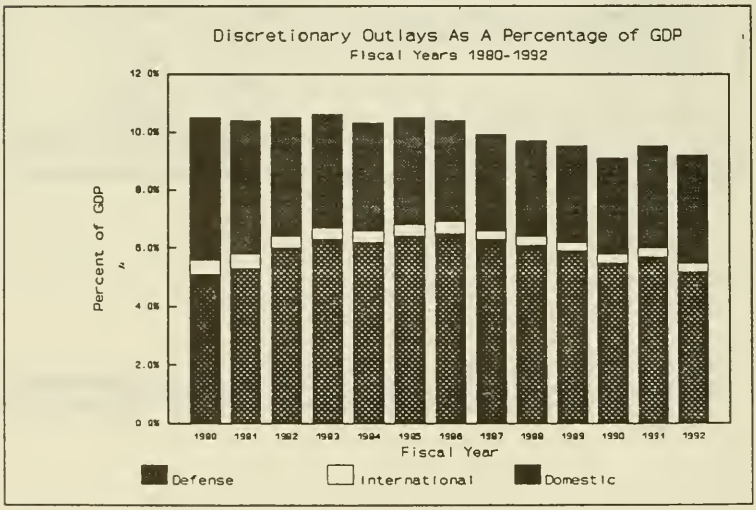


Figure 1

Highlights of Figure I include:

- Discretionary defense peaked at 6.5 percent of GDP in Fiscal Year 1986, but by Fiscal Year 1982 was only 0.1 percent point of GDP above the Fiscal Year 1980 level of 5.0%.

- Discretionary domestic declined steadily from Fiscal Year 1980 through Fiscal Year 1990. Then in Fiscal Years 1991 and 1992, the percentage of GDP for domestic discretionary increased by 0.1 percentage points each year.

- International declined at a very slow rate over this 12-year period.

What Besides Health Care Costs Caused The Increase in the Deficit? -- If entitlement spending other than health and discretionary spending decreased by a total of 1.8 percent of Gross Domestic Product between Fiscal Years 1980 and 1992 (-0.5 for entitlements other than health and -1.3 for discretionary), what besides health care costs caused the increase in the deficit?

Table ID below shows that the net deficit increase of 2.1 percent of Gross Domestic Product from 1980 to 1992 was made up of three items: general tax cuts, increased costs for Medicare and Medicaid, and the explosion in interest costs. A fourth factor in the deficit increase over this 12-year period was the cost of deposit insurance. Because Congress did not enact the appropriation requested for Fiscal Year 1992, outlays were only $2.6 billion in Fiscal Year 1992. In contrast, cumulative outlays over the preceding four fiscal years were $156.4 billion.

Table ID Sources of Increase in Deficit As A Percentage of GDP From 2.8% in 1980 to 4.9% in 1992	Factors Changing Deficit (+) or (-)	
Cause I: Net Tax Decrease, Primarily General Revenues	+1.9%	
Cause 2: Medicare and Medicaid Spending Increase	+1.6%	
Cause 3: Net Interest Spending Increase	+1.4%	
TOTAL DEFICIT INCREASE		+4.9%
OFFSETS TO DEFICIT INCREASE		
Net Social Security (Spending Increase of 0.5 % Minus Tax Increase of 0.9 %)	-0.4%	
Net Entitlement Spending Decrease (Excludes Social Security, Medicare, and Medicaid)	-1.1%	
Net Discretionary Spending Decrease	-1.3%	
TOTAL OFFSETS		-2.8%
Net Increase in the Deficit		2.1%
Note: Detail may not add to totals due to rounding.		

Budgetary Focus on Deficits Undermining Capital Investment and Economic Growth

Over the past fifteen years, macroeconomic and economic growth considerations have been subordinated to efforts to restrain the Federal deficit. The result has been the effective abandonment of standard fiscal tools of the Federal government to affect the economy. It has also led to an under-investment in areas that could stimulate economic growth—the decline in spending for infrastructure is a prime example. Table IE shows the Federal spending for major capital investment as a percentage both of total Federal spending and of GDP.

Table IE
Federal spending for non-Defense major physical capital investment as a percentage of Gross Domestic Product (GDP) and the Federal deficit (or surplus) as a percentage of Gross Domestic Product

Fiscal Years	Infrastructure As a Percentage of Federal Spending	Infrastructure As a Percentage of GDP	Deficit As a Percentage of GDP
1961-70	5.49	1.05	-0.84
1971-80	5.19	1.08	-2.37
1981-90	3.74	0.87	-4.22

Source: OMB, Budget of the United States Government: Fiscal Year 1993, Supplement (February 1992), Part Five, Table 1.3 and 9.2, pp 18,109.

Table IE shows that U.S. Government infrastructure investment was a fairly constant percentage of GDP during the 1960 and 1970's, but dropped significantly in the 1980's. This decline occurred despite the well-documented need for increased spending in this area, estimated by the Congressional Budget Office (CBO) at a shortfall of $240 billion by the end of the century.[3] During the same period, the deficit as a percentage of GDP nearly doubled from the rate for the previous decade. It would appear that the deficit had a direct depressing effect on physical capital investment.

The end of the Cold War highlights the conflict between deficit reduction and government policies to stimulate growth. Ironically, the triumph of the market economy over planned economies coincides with the failure of the United States, the leading market economy in the world, to bring its governmental deficit under control. In addition, the preoccupation with the deficit may cause the United States to miss a tremendous opportunity to increase its productivity and competitive position in world markets. This opportunity, the transition to a post-Cold War economy, requires that the U.S. to retool the defense technological base to strengthen our position in world markets for civilian high technology products and not simply to throw it away to achieve near-term savings.

To a significant extent, the technological advances in the past half century have come out of defense: communications intelligence and thermonuclear weapons development spurred development of automatic data processing; military aviation enabled commercial jet aviation; and avionics spawned solid state electronics. As we down-size the military establishment, neither our governmental structure nor our

---

[3] Congressional Budget Office, Public Infrastructure: Policy Considerations for the 1980's (April 1983)

current budgeting system will direct sufficient resources to sustain technological advances at an internationally competitive level.

Defense research and development remains a significant component of our total research effort. Figure 2 shows the Federal government defense and non-defense research and development expenditures from Fiscal Year 1949 through the President's request for Fiscal Year 1992.

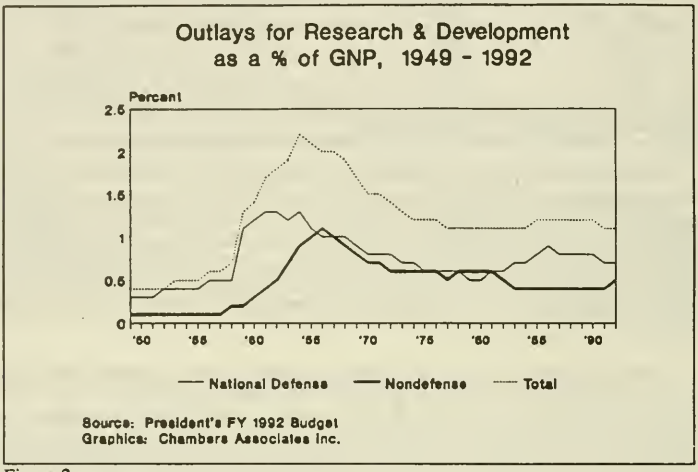


Figure 2

Short-Term Focus and Inadequate Accounting System

The Federal budget primarily focuses on the pending fiscal year, which is called the budget year. Although the OMB budget estimates include projections of anticipated spending and revenue for the four years after the budget year, and congressional budget resolutions typically cover the budget year and the succeeding two years, the focus is the budget year.

This preoccupation with the budget year, which has been institutionalized through devices such as automatic reductions if the deficit is projected to exceed a

certain level, leads to many short-sighted decisions designed to keep spending down in the budget year even at the expense of higher outlays in the out-years.

Cash-based financial management reinforces the political incentives to focus on immediate spending decisions rather than the long-term costs and benefits of government activities. A second way in which current budgetary accounting distorts economic decision-making is the treatment of federally-financed physical capital as a current expense.

Need for a Capital Budget

Capital budgeting would create a framework in which the long-term implications of public resource allocation could be measured. There are four justifications for a capital budget.

The most fundamental justification for a Federal capital budget is to help policy makers weigh the long-term costs and benefits of spending decisions. While president's budgets often contain excellent budget arrays which separate investment and R&D funding from other types of spending, neither in the budgets themselves nor in the congressional review of the budgets are there separate systematic reviews of spending requests which have the potential to increase our productive capacity. Instead, both OMB and the appropriations subcommittees conduct budget reviews by department and agency that do not distinguish between consumption-oriented and investment-oriented spending. With a capital budget, the General Accounting Office (GAO) concludes:

> "Policy decisions on the desired balance between spending for short-term consumption needs (operating expenses) and spending for long-term infrastructure and productivity-enhancing needs (capital investments) could be made on the basis of clearly displayed budget information."[4]

Capital budgeting would help quantify the commonly-held belief that public investment is a worthwhile activity. The Congressional Budget Office has concluded that "carefully chosen federal investments in physical infrastructure such as highway and aviation projects would yield economic rates of return higher than the average return on private capital."[5] CBO also found limited evidence that "federal funding of certain types of research in certain areas offers significant economic benefits."

---

[4] U.S., General Accounting Office, Managing the Cost of Government: Proposals for Reforming Federal Budgeting Practices, GAO/AFMD-90-1 (October 1989), p. 15.

[5] U.S., Congressional Budget Office, How Federal Spending for Infrastructure and Other Public Investments Affects the Economy (July 1991), p. xv.

Health, agricultural, and both basic and academic science and engineering research, CBO concluded, "appear to offer significant economic benefits."[6]

At least 37 states have either a capital budget as a part of their overall budget or as a separate budget.[7] The fact that most states have recognized the value of a capital budget provides further justification for a Federal capital budget. State capital budgeting practices differ markedly among each other and also from private sector accounting practices.

For example, in the private sector, investment typically is not charged as a current expense. The current expense is depreciation on current and past investment. While there is no immediate political pay-off to show charges for depreciation as outlays in a public budget, GAO notes the current clean-up problem in the U.S. nuclear weapons production facilities as an example of the cost of failing to account for depreciation.[8]

No State budget currently includes imputed depreciation.[9] Until validated public sector depreciation estimation techniques can be developed, the Federal government should emulate state practice in implementing capital budgeting and not include depreciation estimates.

There are other limitations to current state capital budgeting practices.[10] First, there is no statutory definition of capital in any State. In 19 states, an asset is capital only if its life will fit with the maturity date of the bonds that finance it. Real property may be included if its cost, anticipated service life, or size exceeds some arbitrary threshold. The second limitation is that these capital budgets are limited in scope. Approximately 13 states combine capital budgets with other budgets. Probably because balanced budget requirements are nearly universal, these combined budgets typically include only capital financed from general revenues, dedicated revenue, or specified funds. Twenty states with capital budgets do charge their capital and/or operating budgets with interest-and-principal payments on capital debt, but most states do not count capital financed with state borrowing.

---

[6] Ibid., p. xvi.

[7] GAO, Managing The Cost of Government, p. 11.

[8] Managing the Cost of Government, pp. 12-13.

[9] Henry Thomassen, "Capital Budgeting For A State," Public Budgeting and Finance, Vol. 10, Number 4 (Winter 1990), p. 85.

[10] These limitations are described in Thomassen, "Capital Budgeting For A State," pp. 72-73.

The third justification for a capital budget is also the oldest one. A capital budget smoothes expenditures and thus eliminates swings in taxation necessary to finance investment. This argument which was made back in 1943 by James Maxwell[11], remains relevant, although it has more validity for State and local budgets than for the Federal budget. The size of the Federal budget makes it difficult to conceive of specific projects that would have a significant impact on total spending in any given year.

The fourth justification for a capital budget is that a more realistic measure of the Federal deficit could be calculated. As Eisner notes, when the private sector invests in new plant and equipment, it is not charged off as a current expense. Instead, only the depreciation is charged as a current expense. If the Federal government followed this practice, the deficit would be much smaller.[12]

A capital budget would allow consumption spending to be distinguished from capital spending. The former does not increase productivity, while the latter has the potential to. From that premise, it follows that capital outlays may be less harmful in terms of the deficit than consumption outlays.[13]

This article does not claim that a capital budget would reduce the Federal deficit. For more than two decades, the Federal budget deficit has an intractable problem. There is now a long history of masking the magnitude of the problem with budgetary "blue smoke and mirrors." If a capital budget were to be implementedas a way to reduce the deficit, the concept would be seen as just another budget game. The importance of a capital budget to deficit reduction is not an immediate reduction in the deficit due to depreciation write-offs instead of expensing investment, which we do not recommend. Instead, the importance of a capital budget is the ability to focus Federal spending in ways that increase economic growth, which would help reduce the deficit over the long term.

A budget presentation that allowed policy makers to distinguish between consumption and investment decisions would be a vast improvement over current practices.

---

[11] James A. Maxwell, "The Capital Budget," Quarterly Journal of Economics, 57 (1943). Cited in Ibid., p. 81.

[12] Robert Eisner, How Real Is The Federal Deficit (New York: The Free Press, A Division of Macmillan, Inc., 1986), p. 30.

[13] The GAO makes this distinction. See: GAO, Managing The Cost of Government, p. 11.

Income Replacement Budget

In addition to a capital budget, the Federal government should also develop a separate income replacement budget for non-means-tested retirement and disability programs as well as Unemployment Compensation. This budget would include the cost of statutory commitments that the Federal government has made to its citizens to provide income replacement when earnings capacity declines due to age, disability, or unemployment. In general, these benefits are tied to wages. These benefits are not welfare payments because applicants need not prove need to claim these benefits. The Federal government's obligation to pay these benefits is not contractual although it is often viewed as such by beneficiaries. Instead the obligation is a political one.

The largest program in the Income Replacement Budget is Social Security. Although Social Security has been by law removed from the budget, the presentation still includes Social Security in the totals. The summary table for the last budget projection issued by the OMB under the Bush administration did not even say that Social Security was off-budget.[14] The Clinton Administration's initial budget presentation, A Vision of Change for America, also did not identify Social Security as an off-budget activity.[15] The statutory requirement that Social Security be off-budget has typically been honored more in the breach than in the observance, notwithstanding the following statutory provision:

Subtitle C-Social Security

"Sec. 13301. Off-Budget Status of OASDI Trust Funds.

(a) Exclusion Of Social Security From All Budgets.--Notwithstanding any other provision of law, the receipts and disbursements of the Federal Old-Age and Survivors Insurance trust Fund and the Federal Disability Insurance Trust Fund shall not be counted as new budget authority, outlays, receipts, or deficit or surplus for purposes of--

(1) The Budget of the United States Government as submitted by the President,

(2) the congressional budget, or

---

[14] See the first table in: U.S., Office of Management and Budget, Budget Baselines, Historical Data, and Alternatives for the Future (Washington: Government Printing Office, January 1993), Table 4.1, p. 45

[15] U.S., Office of Management and Budget, A Vision of Change for America (Washington: Government Printing Office, February 17, 1993).

(3) the Balanced Budget and Emergency Deficit Control Act of 1985."[16]

The following passage from the 1992 CBO annual report gives some insight into why the off-budget status of Social Security is effectively ignored:

> "Policymakers and voters have long considered Social Security special. The program collects payroll taxes from workers and interest on its investments in Treasury securities, and pays benefits to retirees, the disabled, and some of their dependents. In isolation, Social Security runs a surplus because its earmarked income exceeds current benefits and administrative costs. Legislation adopted in 1983 formally placed Social Security off-budget. Since that time, both CBO and the Office of Management and Budget have presented Social Security totals separately, while continuing to stress the usefulness of a total, comprehensive budget....The on-budget deficit has no useful economic meaning. Any number that ignores about one-fourth of the government's taxes and one-fifth of its spending--Social Security's contributions to the totals--is sorely defective."[17]

While advocates of the unified budget effectively ignore statutory provisions that alter the concept, they also ignore some of the 1967 Commission's findings that deal with the special status of trust funds.

> "The budget should include the receipts and expenditures of trust funds. This recommendation fully recognizes that individual trust funds must be accounted for separately, and that their activities must be reported on in a way which allows the identity and integrity of trust fund transactions and balances to be preserved."[18] [Emphasis added.]

> "In recent decades, considerable significance has been attached to the difference between the *Federally owned funds* included in the administrative budget, and the *trust funds* which were excluded. In theory, trust funds do not *belong* to the Federal Government; the Federal Government acts only as *trustee* for them. Old-age and survivors insurance, unemployment insurance, Federally aided highway construction, medicare, and civil service retirement represent some of

---

[16] Section 13301 of the Omnibus Budget Reconciliation Act of 1990.

[17] U.S., Congressional Budget Office, The Economic and Budget Outlook: Fiscal Years 1993-1997 (January 1992), pp. 33-34.

[18] Commission on Budget Concepts, p. 26.

the important and sizable programs handled through trust funds, rather than through Federally owned funds."[19] [Emphasis added.]

A separate Income Replacement Budget would meet the concern for a comprehensive budget expressed so well in this quotation from the CBO report since the spending and revenue totals from the Income Replacement Budget could be combined with the totals from the rest of the budget to arrive at comprehensive totals. At the same time, a separate Income Replacement budget would allow the segregation of Social Security trust fund assets from the rest of the budget.

As the following passage from the Commission's report shows, it did not oppose separate accounting for trust funds:

"The Commission *does not* recommend eliminating the concept of separate trust fund accounting. In many instances, in fact, it sees merit in earmarking specific revenue sources for well-defined programs of a long-run character. The need to respect the integrity of trust funds, and the requirements of control and accountability, in turn require the continued availability of trust fund receipt and expenditure figures separate from those of other funds."[20] [Emphasis added.]

While the Commission supported separate accounting for trust funds, it did not suggest a separate trust fund budget as the following passage from its report shows:

"[T]he Commission believes that the principal significance of trust funds for program decisions lies in an analysis of receipts and expenditures (cost and benefits) of the individual funds rather than in the totals for all trust funds combined, or the totals for Federally owned funds excluding trust funds."[21]

The Income Replacement Budget recommended here would not be a trust fund budget. Some trust funds would be excluded, and some general funds would be included. Instead, the Income Replacement Budget would be a way to analyze in one place the dedicated revenue and the spending for programs that represent statutory obligations to workers.

The Income Replacement Budget would also separate the retirement trust funds for the Federal government's own employees from the rest of the budget. This would

---

[19] Commission on Budget Concepts, p. 26.

[20] Commission on Budget Concepts, p. 27.

[21] Commission on Budget Concepts, p. 27.

make Federal budgetary practice conform more to both private and state government practice. Typically, state budgets include a trust fund budget for the pension plans for its own employees. The Employment Security Retirement Act of 1974, which regulates most private sector pension plans, requires that retirement fund assets be segregated from the rest of a firm's operations and that plan assets not be diverted for any purpose other than payment of benefits and reasonable administrative costs.

The Income Replacement Budget would not be a way to insulate the program from budget discipline. The benefits of current and/or future recipients could be altered, as the House Budget Committee recommended in the Budget Resolution for Fiscal Year 1994. In addition, transfers from general funds, except for interest, would be subject to cuts. These transfers would be made as outlays from the operating budget, which is the residual budget after the Capital Investment and the Income Replacement Budgets are separated out.

Overview of a Restructured Budget

The fiscal policies of the last decade have left a legacy of debt and deficits which have impeded economic growth, and the situation is in fact much worse than is generally known. The challenge is to lay bare the true nature and extent of the deficit, end the budgetary gimmickry that has helped create the current crisis, and set spending and revenue policies on a path that will lead to an end to the unwise and foolish practice of borrowing to finance current consumption. At the same time, it is imperative that the nation invest in its future, in the human and physical capital that will stimulate productivity and economic growth. The budget must become a tool that leads to sound decision making on federal fiscal policy.

To accomplish this goal, the unified budget should be divided into three discrete budgets:

- A Capital Investment Budget which reflects investments for the future and includes expenditures for programs and activities which have multiple-year life and raise future productivity.

- An Income Replacement Budget, which reflects the nation's past commitments made to workers and includes Social Security and Medicare, Federal Employee Retirement programs, and the Unemployment Insurance System.

- An Operating Budget which contains all other programs and activities and reflects current consumption by the federal government.

Each of these budgets is described in detail in Sections II-IV, while Section V summarizes the changes.

SECTION II. CAPITAL INVESTMENT BUDGET

The failure of the budget to make the critical distinction between capital investments and operating expenses hampers and complicates economic decision making. Neither the President nor the Congress have had the ability to identify and set in policy the needed balance between spending for short-term consumption and spending for long-term investments which provide basic infrastructure and/or enhance productivity.

In identifying the appropriate governmental activities to be included in the Capital Investment Budget, this paper draws from the extensive analysis of the Government Accounting Office (GAO), which strongly supports a capital budget. The approach outlined in this article differs somewhat from the current thinking of the General Accounting Office. GAO's latest iteration of budget restructuring would create four budgets: general, trust, enterprise, and investment. Each of these four budgets would have an operating and capital component. The criteria for inclusion in the GAO investment budget is whether it is a tangible or intangible asset that will produce future output and income.

In contrast, GAO's previous definition of capital includes both federal capital, such as federal office buildings, defense weapons, and developmental capital, such as loans, grants for infrastructure, research and development, and education and training. The purpose for this distinction is to separate federal outlays acquired for operating the government from outlays that are made to promote economic growth. While the GAO concept is interesting, it is very complex and amounts to the substitution for one unified budget of eight separate budgets. For that reason, this paper does not recommend adoption of the GAO model, although there are many similarities between this proposal and the GAO model.[22] The Office of Management and Budget has not supported establishment of a federal capital budget, although it develops capital outlay estimates that are utilized in this paper.

The Capital Investment Budget (CIB) proposed here will report both capital revenues and capital investments. Capital revenues include all taxes and user fees which are earmarked by law to finance specific capital investments. Capital revenues

---

[22] The formal GAO proposal is included in: U.S., General Accounting Office, Managing The Cost of Government: Proposals For Reforming Federal Budgeting Practices, GAO/AFMD-90-1 (October 1989). Current GAO thinking on this issue is contained in a September 1992 discussion memorandum that has been circulated to a small number of academics. The most recent public GAO position was included in the testimony of Paul L. Posner, Director of Budget Issues, Accounting and Financial Management Division, General Accounting Office, before the Subcommittee on Legislation and National Security, Committee on Government Operations, U.S. House of Representatives (July 23, 1992).

also include loan interest and principal repayments and interest paid by the Treasury on securities held by capital trust funds.

Capital investments include the subsidy cost of loans which increase investment. This is consistent with the credit reform enacted by the Congress in 1990 and is the treatment currently recommended by the GAO.

The treatment of depreciation in the CIB will differ from private sector practice in a fundamental way. The private sector typically integrates accrual accounting, including depreciation, into its financial management system. In contrast, the U.S. government's financial management system is on a cash basis. The reason for this is that the Congressional appropriations process exerts its control over executive branch spending at the point of obligation of funds. An executive branch official who obligates funds for which there is not a congressional appropriation is in violation of the Anti-Deficiency Act of 1905. The Anti-Deficiency Act, which prescribes criminal penalties for violation, is a codification of the long-standing Anglo-American tradition of legislative control over appropriations.

The total integration of accrual accounting, including depreciation, into executive branch financial management could weaken the control through the obligations process, and would precipitate strenuous opposition. For that reason, appropriations should continue to be on a cash basis and accrual measurements, including depreciation, should be part of the budget presentation, but not the basis for appropriations actions or financial management.

Nevertheless, a depreciation schedule should be developed and subtracted from the total of all capital investments, resulting in the net capital investment amount. The amount by which net capital investments exceed capital revenues has been termed by GAO as "capital financing requirements." GAO uses this term, rather than "capital deficit" in order to reflect the fact that the government is financing a capital asset which has value and will produce a stream of benefits in the future. As noted previously, this schedule should not be applied to the capital budget until validated depreciation estimates are developed. This will require the valuation of Federal assets that would be subject to depreciation, and the development of agreed-upon depreciation rates. The development of public sector depreciation rates in theory should be easier than the private sector in which depreciation estimates are affected by the tax code. In contrast, the valuation of current public assets will be extremely difficult. It is crucial to the development of capital budgeting that this effort not become tied up with budgetary politics about the deficit.

The guiding principals used in determining which programs and activities are capital assets which should be included in the Capital Investment Budget can be summarized in the following questions:

What has multiple year life?

What raises future productivity?

The answers to these questions has led us to identify, in addition to the physical capital which GAO included in its capital budget, options to include research and development (R&D) activities (both defense and civilian) and human capital investments, such as education and training, all of which GAO excluded from its initial 1989 recommendation capital budget, although it is currently considering the inclusion of many of these items in its investment budget. At the same time, it has led us to exclude defense procurement because it fails to meet the test of raising future productivity. Defense weapon systems and related equipment in the concept developed for the Capital Investment Budget can be compared to consumer durable, not to capital investment.

Most States currently have separate capital and operating budgets. Typically, the capital budget is financed through the issuance of long-term debt instruments and through dedicated revenue sources, particularly user fees. The operating portion of State budgets, including the cost of servicing the debt of the capital budget is the part of State budgets that is typically subject to statutory or state constitutional balanced budget requirements. An important distinction between the proposed CIB and State and local government capital budgets is that the CIB would be a vehicle to facilitate decisions on the appropriate level of public investment, while State and local capital budgets primarily reflect financing mechanisms.

There will be substantial political pressure from congressional authorizing committees and from interest groups to include their favored programs in the CIB. The presumption will be that inclusion in the CIB might make a program immune from cuts and garner support for increased funding. Such a presumption would be false if the programs in the CIB are assessed in terms of rate of return. That is the criteria used in the private sector in making investment decisions. Unfortunately, this criteria is seldom applied in Federal government investment decisions because meaningful rate of return estimates are seldom made. Using rate-of-return as a decision criteria could well become an incentive against inclusion in the CIB of programs with mushy objectives and no way to assess effectiveness. On the other hand, in some areas such as basic research and development, rate of return estimates may be impossible to develop.

In addition to using the rate of return, wherever feasible, as a criteria to determine whether an investment should be undertaken, we recommend that a process be created to screen any additional programs that may be proposed in the future for inclusion in the capital investment budget. An Advisory Committee consisting of the comptroller general, the director of the Congressional Budget Office, and the director of the Office of Technology Assessment should be created to advise

on recommendations for inclusion of new programs in the Capital Investment Budget. To avoid a constitutional challenge, this committee should be advisory only.[23]

The following series of tables set forth the proposed Capital Investment Budget (CIB). These tables include Fiscal Year 1991 actual expenditures in these areas and estimates for 1992 and 1993. (Section V of this document includes a FY 1994 baseline estimate for the CIB.)

To keep the estimates comparable and because OMB updates the detailed breakdowns that are required to construct these tables only once a year, the tables in Part II use the estimates that were included in the Bush February 1992 budget. Of significance in the current executive branch decision-making process is that these OMB annual estimates are pulled together after the President and the OMB Director have made the decision on the budget. Thus, they are **ex post facto** informational presentation, not part of the budgetary decision process.

These OMB estimates contain a number of program activities that are part of an appropriation. In contrast, the Appropriations Committees make their decisions on the basis of individual appropriations accounts. If the CIB is to become a decision-making vehicle rather than simply an ex post facto informational presentation, the basic data set will have to be entire accounts. The alternative would be to propose to the Appropriations Committees that they appropriate on a basis other than individual accounts. It is highly unlikely that this would be acceptable to those committees.

Physical Capital Investment - Defense Related

Table IIA sets forth National Defense Outlays for Major Public Direct Physical Capital Investment as estimated by OMB in a illustrative capital budget that was included for comparison purposes in the Bush Fiscal Year 1993 budget and as proposed in the Capital Investment Budget (CIB).

---

[23] The constitutional issue is that the preparation of the President's budget is the responsibility of the Executive Branch, and these three officials are part of the Legislative Branch. The President cannot delegate executive responsibilities to the Congress.

TABLE IIA – NATIONAL DEFENSE OUTLAYS
FOR MAJOR PUBLIC DIRECT PHYSICAL CAPITAL INVESTMENT:
1991 - 1993
(IN BILLIONS OF DOLLARS)

		Department of Defense–Military				Atomic Energy and Other Defense		
OMB ILLUSTRATIVE PRESENTATION								
Fiscal Year	Total	Total Defense	Procurement	Military Construction	Family Housing	Total	Reheb. of Phys. Assets	Major Equipment
1991....	87.22	85.33	82.06	2.87	0.40	1.89	1.28	0.62
1992 est	79.99	78.03	73.95	3.57	0.51	1.97	1.23	0.74
1993 est	74.84	72.94	67.26	5.02	0.66	1.90	1.28	0.62
CIB RECOMMENDED PRESENTATION								
1991....	4.55	3.27	NA	2.87	0.40	1.28	1.28	NA
1992 est	5.30	4.07	NA	3.57	0.51	1.23	1.23	NA
1993 est	6.96	5.68	NA	5.02	0.66	1.28	1.28	NA

Source for OMB Illustrative Presentation: Budget of the United States Government Fiscal Year 1993 (January 1992), Part Three, pp. 35-54.

The difference between the OMB illustrative presentation and the recommended total for the CIB is that the CIB excludes defense procurement. The General Accounting Office is currently reconsidering its position on defense procurement and will in all likelihood exclude it from the investment budget in its next version of a budget restructuring. The GAO distinction under consideration is to exclude federally-owned capital programs that have as their principal purpose acquisition of assets to help federal agencies achieve their missions, unless the agency's mission is investment in nature.

Physical Capital Investment - Civilian

Table IIB sets forth Civilian Outlays for Major Public Physical Capital Investment. This table includes direct federal investment as well as investment financed through grants. The estimates are those developed by OMB in February 1992 for the Bush budget.

Table 18 – COMPOSITION OF NON-DEFENSE OUTLAYS FOR DIRECT CAPITAL INVESTMENT AND FOR GRANTS FOR MAJOR PUBLIC PHYSICAL CAPITAL INVESTMENT: 1991 - 1993
(in billions of dollars)

Category	1991	1992 est.	1993 est.
DIRECT CAPITAL INVESTMENT			
Water and Power Projects			
Corps of Engineers	1.69	1.49	1.68
Bureau of Reclamation	0.67	0.87	0.50
Bonneville and other power marketing agencies	0.18	0.27	0.38
TVA	1.31	1.47	2.16
Nuclear and other	0.86	0.97	1.08
Other	6.14	8.03	7.93
Acquisition of major equipment	5.48	6.14	7.08
Total: Direct Capital Investment	16.33	19.22	20.80
GRANTS			
Transportation:			
Highways.....	14.20	15.70	16.87
Urban mass transportation 1/.....	3.23	3.16	2.90
Airports.....	1.54	1.56	1.76
Other.....	---	---	•
Total transportation.....	18.96	20.41	21.53
Community and regional development:			
Block grants.....	2.98	3.13	3.34
Urban renewal.....	---	---	---
Public works acceleration/local public works.....	---	---	---
Other.....	0.76	0.86	0.78

24

Total community and regional development.....	3.74	3.99	4.11
Natural resources and environment:			
Pollution control facilities.....	2.71	2.54	2.51
Other.....	0.76	0.80	0.79
Total natural resources and environment.....	3.48	3.34	3.30
Other non-defense:			
Education, training, employment, and social services....	0.03	0.06	0.03
Health.....	---	---	---
Other functions.....	0.22	0.26	0.60
Total other non-defense.....	0.25	0.32	0.64
Total, non-defense.....	26.42	28.06	29.58
National defense 2/.....	0.11	0.09	0.02
Total: Grants	26.53	28.14	29.60
GRAND TOTAL: DIRECT AND GRANTS	42.86	47.37	50.40
1/ Includes relatively small amounts for railroads.			
2/ National Guard shelters and civil defense.			
Source for estimates: Budget of the United States Government Fiscal Year 1993 (January 1992), Part Three, pp. 35-54.			

Some comments on Table IIB include:

- Direct capital investment is less than half of investment financed with grants to State and Local governments, averaging 40 percent over the three-year period, Fiscal Years 1991-1993.

- Within the Federal direct category, the majority of the funding goes for water and power projects.

- Within the grant category, transportation accounts for the largest percentage of grant funding, averaging 40 percent over the three-year period, Fiscal Years 1991-1993.

- The education and health funding included in Table IIB is only for investment in physical structures and equipment.

- The programs recommended for inclusion as public physical capital investment in Table IIB match the GAO recommendation for an investment budget, except that GAO excludes community and regional development.

The treatment of community and regional development funding is a difficult choice. In recent years, the only funding has been through block grants. In general, block grants should not be included in the CIB because by definition, it is difficult to calculate rates of return if funds are given to states with broad discretion in how they will be spent. On the other hand, there is no question that community development block grants represent an important way to encourage development of infrastructure in urban areas. For that reason, even though it is inconsistent with the criteria that block grants not be included in the CIB, we recommend the inclusion of community development funding in the CIB on the grounds that it is used primarily for infrastructure investment. Decisions made with regard to future plans for community development funding should be considered in making the decision as to whether such funding should be included in the CIB.

Research and Development (R&D) Investment

Table IIC sets forth the composition of R&D Outlays for Defense and Civilian programs proposed for inclusion in the CIB.

Table IIC – COMPOSITION OF OUTLAYS FOR THE CONDUCT OF RESEARCH AND DEVELOPMENT: 1991 - 1993 (in billions of dollars)			
Category	1991	1992 est.	1993 est.
National defense:			
Department of Defense...	35.33	36.93	38.91
Atomic energy defense...	6.34	7.10	6.70
Total national defense.....	41.67	44.03	45.61
Non-defense:			
General science, space, and technology:			
NASA.....	6.28	6.36	6.75
NSF.....	1.63	1.84	2.06
Atomic energy general science.....	0.83	0.95	1.25
Subtotal: general science, space, and technology	8.74	9.15	10.06
Energy.....	2.50	3.07	3.23
Transportation:			
DOT.....	0.33	0.41	0.46
NASA.....	0.80	0.91	0.96
Subtotal: Transportation	1.13	1.32	1.41
Health:			
NIH.....	7.26	7.93	8.54
Other.....	1.27	1.49	1.61
Subtotal.....	8.53	9.42	10.16
Agriculture.....	0.99	1.07	1.12
Natural resources and environment.....	1.32	1.54	1.52
All other	1.09	1.26	1.35
Total non-defense	24.30	26.82	28.85
Total conduct of research and development	65.97	70.86	74.46

There are several conceptual problems in the inclusion of research and development in the CIB.

The first is that basic research by its very nature cannot be subjected to rate of return analysis. Basic research is intended to increase the knowledge base, not to result in a identifiable payoff. If the payoff is identifiable, it generally would be applied research or development. The OMB estimate of outlays for basic research in the Fiscal Year 1993 budget was $13.4 billion.[24] Excluding basic R&D from the CIB creates a dilemma. Basic R&D is an important part of federal support for technological advancement and should lead to promising projects for applied R&D.

The second conceptual issue is how to treat defense R&D. GAO's current thinking seems to be to exclude applied defense R&D, which OMB estimated at $40.3 billion in the Fiscal Year 1993 budget but to include basic defense research, which OMB estimated to be $1.3 billion. The GAO feels that defense applied R&D should be excluded from investment because such applied research is generally not transferrable to a civilian application. Inclusion of defense R&D in the CIB could focus the attention of Defense Department leadership on recent criticisms that defense R&D has become less and less relevant to real world applications, and could result in improved transferability to civilian applications.

If the recommendation is adopted that defense procurement should not be included in the CIB, it would be inconsistent to include in the CIB the applied R&D that is undertaken prior to the procurement decision. On the other hand, given the demonstrated historical pay-off to the economy of some past defense R&D, such as ADP originally undertaken for purposes of communications intelligence (COMINT) and atomic energy, and radar development for air defense, it would appear incongruous to exclude it, while including domestic R&D.

The treatment of R&D in the CIB is an example of the tortuous debates that can be generated about what programs are appropriate to include in any type of capital budget. One option is to apply a simple, albeit arbitrary, approach be followed, assess R&D requests for all agencies, including defense, against two criteria:

(1) How the R&D will help the agency achieve its mission, and

(2) How the R&D will help economic growth and competitiveness.

Under this approach, all Federally-funded research and development would be included in the capital budget and assessed as an end-product that increases the knowledge base, not as an investment that must be followed by procurement of a

---

[24] Source: OMB, The Budget For Fiscal Year 1993, Table 6-2, Part One, p. 94. This is a different breakdown of R&D spending than is included in the Tables IIC-D.

product. Indeed, a decision following basic and applied research not to procure does not mean that the investment was a waste. It means that an increased knowledge allowed policy makers to avoid making an unwise procurement of a capital good. This rationale would support the previous option not to include defense procurement in the CIB, and to include defense R&D.

Clearly, there may be objections to subjecting defense R&D to the both the agency mission and the economic growth criteria. While in fact, DOD over the years has publicized the civilian by-products of defense R&D, the Joint Chiefs would likely resist any erosion of the principle that the budget allocations should be made in terms of each services' military mission. If the services' opposition is too strong, an obvious alternative is to exclude defense R&D from the CIB.

Human Capital Investment

A major issue in a capital budget is what, if any, human resource programs to include. If state practice is a guide, none should be included. Thomassen notes that intangible capital, such as investment in "human" or "intellectual" capital is not included in any state capital budgets.[25]

On the other hand, GAO notes that many private sector researchers consider many human resource programs as an investment. In particular, most researchers would categorize spending for education and training programs as an investment.[26] On programmatic grounds, however, there is a basis for a distinction between federal and State and local budgetary treatment of education as an investment. State and local governments finance most public education in the United States. The Federal government funds elementary and secondary education essentially for two purposes:

(1) to provide seed money for innovation, and

(2) to reduce funding disparities because of differing state and local tax bases as well as concentrations of disadvantaged students with greater educational needs in certain communities and states.

Clearly, the first purpose is a form of investment. The second is essentially based on the assumption that there is a national interest in providing adequate educational opportunities for all jurisdictions, regardless of their taxing ability and the number of students with special needs. This can be justified as a form of public investment.

---

[25] Thomassen, "Capital Budgeting for a State," p.p. 72-73.

[26] U.S., General Accounting Office, Human Resource Programs Warranting Consideration As Human Capital, GAO/AFMD-90-52, p. 4.

There remain, however, significant conceptual and measurement problems if human resource programs whether education and training or others are included in the CIB. The first issue is to calculate rate of return. Particularly, where the Federal investment is only part of the cost, this poses significant methodological problems. The second issue is to separate the investment and consumption components.

Table IID sets forth the composition of outlays for the Conduct of Education and Training as proposed as an option for inclusion in the CIB.

Table IID – COMPOSITION OF OUTLAYS FOR THE CONDUCT OF EDUCATION AND TRAINING 1991 - 1993 (in billions of dollars)			
Category	1991	1992 est.	1993 est.
Direct Federal outlays:			
Elementary, secondary, and vocational education..	0.86	0.84	0.85
Higher education.....	12.26	11.11	14.08
Training and employment assistance.....	0.88	0.99	1.05
Health (incl. Veterans).	1.33	1.48	1.47
Veterans education, training and rehabilitation....	0.80	1.07	1.23
All other.....	1.65	1.82	2.03
Total Direct.....	17.77	17.31	20.70
Grants to State and local governments			
Elementary, secondary, and vocational education (including Headstart)	10.44	12.14	12.91
Higher education.....	0.08	0.11	0.10
Research and general education aids.....	0.48	0.52	0.50
Training and employment assistance.....	2.99	3.15	3.19
All other.....	1.03	1.37	1.46
Total Grants.....	15.02	17.28	18.16
Total conduct of education and training.....	32.79	34.60	38.86

Table IID includes all funding included in the OMB illustrative presentation for a capital budget with the exception of Social Services funding. All of this funding is for the conduct of education and training, not for investment in physical structure. The relatively small Federal education investment in physical structures was shown in Table IIB. A subsequent section of this paper deals with the issue of whether Social Services funding should be included. Grants and loans for post secondary

education and the National Service Trust fund would be included in the CIB in this category, as would training and employment assistance programs.

Other Human Capital Investment

Other programs and activities which promote the health and well being of individuals could be characterized as "investing" in their further productivity. Taken to its extreme, any program which provides food, health services, housing or income with which to purchase such products and services could be identified as human capital programs. While this may be a useful and legitimate construct for some purposes, too inclusive a capital budget would make the concept meaningless. Therefore, we have not developed an option for including basic health and social programs in the capital budget.

There are a few programs, however, for which a reasonable case could be made. These options are set forth in Table IIE. Considered in isolation, each program in Table IIE is defensible as an investment. On the other hand, inclusion of each makes it more difficult to make distinctions from other programs which are not included. Therefore, we recommend that these programs not be included in the CIB.

Table IIE – POSSIBLE CANDIDATES FOR INCLUSION IN THE CAPITAL INVESTMENT BUDGET 1991-93 (in billions of dollars)

	1991	1992 est.	1993 est.
Child Nutrition	5.54	6.10	6.39
Women, Infants and Children Nutrition Assistance (WIC)	2.28	2.63	2.68
Maternal and Child Health Block Grant	0.59	0.65	0.67
Childhood Immunization	0.22	0.30	0.35
Social Services Block Grant (Title XX)	2.83	2.79	2.80
Total	11.45	12.46	12.89

Direct and Guaranteed Loans

Included in the proposed CIB options are the economic impact of Federal direct and guaranteed loans that increase future productivity. Such credit activities should be assessed against the rate of return criteria as is proposed for direct Federal spending. The cost of Federal credit in the investment budget is the cost of the

subsidy. This treatment is consistent with the credit reform provisions enacted in 1990. This treatment is also consistent with GAO's thinking on this matter.

Table IIF shows Fiscal Year 1993 outlays as estimated by OMB in February 1992 for the subsidy cost of direct and guaranteed loan programs that are proposed for inclusion in the CIB. These estimates are informational only. The subsidy costs of these programs was subsumed in the earlier tables.

Table IIF Subsidy Outlays for Direct and Guaranteed Loans Fiscal Year 1993 (in billions of dollars)	
Direct Loans	
Rural Development Insurance Fund	0.01
Rural Development Loan Fund	0.00
Rural Electrification Administration	0.12
Small Business Administration: Disaster Loans	0.06
Small Business Administration: Business Loans for Handicapped Assistance	0.01
Total Direct Loans	0.20
Guaranteed Loans	
Rural Development Insurance Fund	0.01
Agricultural Resource Conservation Demonstration	0.00
Rural Electrification Administration	0.00
Guaranteed Student Loans: Stafford	2.07
Guaranteed Student Loans: PLUS	0.10
Guaranteed Student Loans: SLS	0.29
Health Professions Graduate Student	0.02
Indian Loan Guaranty and Insurance Fund	0.01
Small Business Administration Business Loans	0.13
Total: Guaranteed Loans	2.64
Total: Direct and Guaranteed Loans	2.84

Table IIG on the following page is a list of the direct and guaranteed loan programs in the Credit Budget that the Federal government conducts that are not included in the CIB options.

Table IIG Subsidy Outlays for Direct and Guaranteed Loans Excluded From the Capital Investment Budget Fiscal Year 1993 (in billions of dollars)	
Direct Loans	
Foreign Military Financing	0.01
Overseas Private Investment Corporation	0.00
Agricultural Credit Insurance Fund	0.11
Rural Housing Insurance Fund	0.34
Public Law 480 Export Credits	0.34
Housing and Urban Development: Restore Loans	0.02
State Department: Repatriation Loans	0.00
Veterans Loan Guaranty Revolving Fund	0.07
Veterans Guaranty and Indemnity Fund	0.02
Export-Import Bank	0.03
Total: Direct Loans	0.93
Guaranteed Loans	
AID	0.00
Overseas Private Investment Corporation	0.00
Agricultural Credit Insurance Fund	0.07
Rural Housing Insurance Fund	0.09
Commodity Credit Corporation: Export Credits	0.16
Federal Housing Administration Mutual Mortgage	-1.39
Federal Housing Administration General and Special Risk	0.13
Veterans Guaranty and Indemnity Fund	0.19
Export-Import Bank	0.21
Total: Guaranteed Loans	-0.54
Total: Direct and Guaranteed Loans	0.40

Some comments on programs that are recommended for exclusion.

- Federal direct spending programs to provide housing assistance for low-income persons are not proposed for inclusion in the CIB. They are excluded because Federal efforts in this area are an in-kind benefit that supplements income. There is virtually no federal assistance for financing the construction of low income housing. Even if there were, most economists would argue that housing is a consumer durable and thus should also be excluded.

- All credit programs designed to stimulate foreign trade, foreign military sales, and foreign assistance are excluded on the grounds that if they are an investment, they are not a domestic investment. In addition, the Export-Import Bank is excluded. It provides a subsidy to Americans firms, but does not directly stimulate investment.

- Agriculture credit which finances crop production or finances rural housing is excluded. The former is a subsidy to agricultural producers, whose output is a consumption item. The treatment of the latter is consistent with the recommendation for housing credit in general.

Table IIH is a summary table of funding for the programs proposed for inclusion in the Capital Investment Budget.

Table IIH -- Activities Included in CIB Based on OMB February 1992 Estimates for Fiscal Year 1993 (in billions of dollars)	
National Defense Outlays for Direct Investment (Excludes Procurement)	5.7
Non-Defense Outlays for Direct Capital Investment	20.8
Non-Defense Grants for Major Public Physical Capital Investment	29.6
Subtotal: Non-Defense Direct Outlays and Grants for Capital Investment	50.4
Defense and Non-Defense Basic and Applied Research and Development	74.5
Human Capital: Education and Training	38.9
Totals	169.5

Financing of Capital Investment Budget

Table II-I shows how the programs proposed for inclusion in the CIB budget are financed. As with the previous tables in this section, the estimates are based on the OMB February 1992 estimates for the Fiscal Year 1993 Budget.

Table II-I Financing of Capital Investment Budget Based on OMB February 1992 Estimates (in billions of dollars)	
Excise Tax and Misc. Receipts To Trust Funds	
Highway	17.7
Airport and Airway	5.7
Aquatic Resources Trust Fund	0.3
Inland Waterway Trust Fund	0.1
Hazardous Substances Response Trust Funds	0.8
Oil Spill Liability Trust Fund	0.3
Leaking Underground Storage Tank Trust Fund	0.1
Subtotal: Excise Tax and Misc. Receipts To Trust Funds	25.0
Interest Payments to Trust Funds	
Highway	1.5
Airport and Airway	1.2
Subtotal: Interest	2.7
Total: Interest, Excise Tax, and Misc. Receipts	27.7
Total: Outlays	169.5
Amount Financed Through Appropriations From General Funds	141.8

SECTION III. INCOME REPLACEMENT BUDGET

Unlike the private sector, where businesses cannot include pension assets held on behalf of individuals, either in their assets or their bottom lines, the federal government places in its annual budget the surpluses from:

- the pension systems provided for its own employees,
- the Social Security system which provides a base retirement and disability program for all U.S. workers, and
- the unemployment insurance system which collects a state tax from employers to provide benefits to unemployed workers while they look for jobs.

This accounting practice has created great distortions in the federal budget and has masked the true nature and size of federal deficit spending.

Using trust funds to mask deficits distorts the purposes of the trust funds.

A good illustration of the problems resulting from the use of trust fund surpluses to mask deficits is the recent controversy over extension of unemployment insurance benefits. At the time that President Bush vetoed extended benefits early in 1992, there was a total balance of $47.5 billion in the unemployment insurance trust funds, enough to provide extended benefits, as was done in other recent recessions, to all long term unemployed workers who had exhausted their benefits and were still looking for work.

These funds were denied to unemployed workers for months when the funds were paid in as taxes by employers to be used for this purpose. The budget process held the unemployment trust fund hostage to help finance the record Federal deficit.

The notion that an extension of unemployment benefits in a recession must be deficit-neutral in the Federal budget turned the traditional approach to financing this system upside down. The original goal of the unemployment insurance program was to run surpluses in good times and deficits in hard times, with surpluses rebuilt in the following recovery.

The Budget Enforcement Act, which the Bush Administration invoked as a justification for their position, held the trust fund to a new standard, that unemployment insurance should be deficit-neutral even during periods of high unemployment, and surpluses in the Trust Funds cannot be used for their intended purpose. Over the months that Bush and the Congress wrangled over extensions of benefits, the balances in these funds increased by half a billion dollars.

Unified Budget Understates Operating and Interest Expense

Although the federal government must pay interest each year on all the funds it has borrowed in the past, the interest the government pays to trust funds and to other Federal entities does not show up in the bottom line of the budget or in the deficit calculation. Instead, interest paid to trust funds and other Federal entities is subtracted from total interest payments before the interest amount is reported in the federal budget.

This creates a perverse incentive for budget officials to propose cuts in spending for these programs. For instance, if $5 billion were cut from social security benefits, the balance in the Trust Fund would be $5 billion higher because of the benefit reduction, and the deficit would appear to be $5 billion less even though the government is actually borrowing the $5 billion which one day will have to be repaid to the Trust Fund. Moreover, the interest that the government will owe every year on that $5 billion will also not show up in the federal budget.

Finally, when the federal government owes payments to these Trust Funds as required by law to finance contributions as an employer on behalf of its own employers, for social security, unemployment insurance, or federal employee pensions, the payment is made by the employing government agency and counts as spending for that agency, but it is then subtracted from the budget in a special budget function called "Undistributed Offsetting Receipts." In this way, the unified budget hides the cost of the government providing benefits to its own employees. The payroll taxes, pension contributions, and unemployment insurance payments which a private sector firm pays for its own employees are clearly recognized as an immediate cost in the firm's accounting. The same should be true in the federal budget.

Programs in Income Replacement Budget

Table IIIA sets forth the programs proposed to be included in the Income Replacement Budget.

Table IIIA – INCOME REPLACEMENT BUDGET 1991-94 (in billions of dollars)			
	1992 est.	1993 est.	1994 est.
Social Security	287.57	304.21	321.24
Railroad Retirement	4.61	4.55	4.56
Other General Retirement	1.01	1.01	0.97
Federal Civilian Employee Retirement and Disability	33.94	34.91	36.85
Military Retirement	24.44	25.64	26.95
Other Federal Employee Retirement and Disability	0.02	0.09	0.07
Veterans Compensation	12.69	12.71	13.68
Unemployment Compensation	40.04	34.28	28.21
Total:	404.33	417.40	432.52
Source: CBO Summer 1992 Baseline			

Most of the programs proposed for inclusion in the Income Replacement Budget are financed through trust funds in which dedicated revenue is earmarked to finance benefits and administrative costs. The major exception is Veterans Compensation, which is financed with general revenues and functions as a form of disability and worker compensation program for former military personnel and their survivors. Benefits in Veterans compensation are tied to injuries, wounds, or death while in military service. They are not means-tested. No means-tested programs are proposed for inclusion in the Income Replacement Budget. For that reason, Veterans pensions are not recommended for inclusion since benefits in this program are tied to current income and assets.

Medicare is not proposed for inclusion in the Income Replacement program although it is part of the federal government's commitment to workers. Medicare does not increase the incomes of individual recipients by the amount of the health benefits they receive. If that were true, a terminally-ill individual would be counted as very wealthy. Thus, from that perspective, it is not an income replacement

program. At best, the income supplement is the insurance value of Medicare benefits.

Social Security is the largest program in the Income Replacement Budget. By law, Social Security is not in the Federal budget. Congress in three separate laws over the past decade has directed that Social Security be off-budget. This law has been honored more in the breach than in the observance. Placing Social Security in the new Income Replacement Budget has the advantage of keeping Social Security out of the operating budget, consistent with Congressional Intent in taking Social Security off-budget.

Accounting Treatment Trust Funds in the Income Replacement Budget

The accounting for statutorily required payments to these Trust Fund will be treated in the Restructured Budget as follows:

(1) All revenue from whatever source will count as revenue to the appropriate Trust Fund. Revenues to these Trust Funds will not be aggregated with other revenues. Estimated revenues for Fiscal Year 1993 are shown in Table IIIB below.

(2) Revenues to these Trust Funds which are received from the general fund will be counted as outlays from the general fund. Interest paid to these trust funds will be included as outlays from the general fund in Function 900: Interest. This function is currently named Net Interest because interest payments to trust funds and other government entities are netted out of the total. Under the Restructured Budget Proposal, the interest function will show all interest payments. Pension contributions and payroll taxes will be paid from the general fund to the appropriate trust fund and will be counted as outlays in the budget of the employing agency, as is now the case, but they will not be subtracted from outlays, as they are now, in the "Undistributed Offsetting Receipts" section of the budget.

This Income Replacement budget will be totally separate from the Operating Budget, which will hopefully end the manipulation of programs solely for the purpose of masking the operating fund deficit. Surpluses from the programs will still be invested in Treasury securities as they are now, but the borrowing and associated interest payments will be made explicit. An issue distinct from but related to creation of the Income Replacement Budget, is whether such funds could or should be invested outside of Treasury securities.

For instance, Social Security surpluses could, by law, be invested in interest-bearing obligations of the United States or obligations guaranteed as to interest and

principal by the United States.[27] However, the Secretary of Treasury, who is the Managing Trustee of Social Security funds, has chosen to invest only in special issue securities that bear interest equal to the average for securities that are callable or have a maturity date four of more years beyond the date that the special issues are issued. There have been proposals to invest in other activities that will promote economic growth, for instance for infrastructure investment. Changing the investment policies for social security surpluses, and/or federal employee pension assets should only be undertaken after careful study to determine that risk can be limited to acceptable levels.

Budget Estimates for Income Replacement Budget

Table IIIB gives more detail on the major trust fund programs proposed for inclusion in the Income Replacement Budget. The estimates are based on those included in the February 1992 budget. The program detail necessary to develop these estimates is not included in the CBO baseline, nor is it published by OMB other than when the annual President's budget is transmitted.

[27] Section 201(d) of the Social Security Act.

Table IIIB
Sources of Revenue to the Major Trust Funds
Proposed for Inclusion in the Income Replacement Budget
Fiscal Year 1993
(in billions of dollars)

	Social Insurance Taxes and Contributions	Interest on Trust Fund Balances	Government Payment As An Employer	Other	Total Income to Trust Funds
Social Security (OASDI)	325.8	27.0	6.4	6.5	365.7
Railroad Retirement	3.8	0.8		3.2	7.8
Unemployment Compensation	25.6	2.5		0.9	29.0
Federal Employee Retirement Programs					
Federal Civilian Retirement	5.1	25.3	12.7	20.3	63.4
Federal Military Retirement	0.0	10.2	15.8	11.7	37.7
Total: Major Trust Funds in the Proposed Income Replacement Budget	360.3	65.8	34.9	42.6	503.6

* This is the voluntary premium for SMI. It is treated as an offsetting collection which reduces net outlays.

Table IIIB shows that the income to the major trust funds proposed for inclusion in the Income Replacement Budget is estimated to be $503.6 billion in Fiscal Year 1993. The largest source of this revenue is dedicated taxes, which will be $360.3 billion. Payments, by the Federal government as an employer such as the employer share of FICA which finances Social Security, while not counted as taxes, add $34.9 billion in revenue.

The second largest source of revenue to the trust funds is interest earned on trust fund balances, which OMB estimated in February 1992 would be $65.8 billion to these trust funds during Fiscal Year 1993. These interest payments will be made from the operating budget.

The next largest source of revenue to the trust funds is the other category, which is primarily payment with general funds of specific benefits or statutory transfers to finance the program. This category will total $42.6 billion in Fiscal Year 1993. The next largest payment is $34.9 billion for Federal employee and military retirement. This includes interest payments on the portion of the unfunded liability that is in part attributable tc the Federal government's past failure to fully fund the system. It also includes amortization payments for liberalizations in benefits, including

cost-of-living payments. All of these payments are currently netted out in the bottom line of the budget. Under the Budget Restructuring proposal, these payments would all count as outlays in the bottom line of the operating budget. The operating budget would be the arena in which the President and the Congress could debate whether these payments were appropriate or not.

Table IIIC shows the change in the balances during Fiscal Year 1993 of the major trust funds proposed for inclusion in the Income Replacement Budget. It should be noted that the estimates, including the outlay estimates, are based on the Bush February 1992 budget. In contrast, Table IIIA included more recent CBO estimates, which cannot broken down to develop trust fund balance estimates.

Table IIIC
Trust Fund Balances
In Income Replacement Budget
Fiscal Year 1993
(in billions of dollars)

	Balance Start of Fiscal Year 1993	Total Income to Trust Funds	Total Outlays From Trust Funds	Miscellaneous Adjustments	Balance End of Fiscal Year 1993
Social Security (OASDI)	318.6	365.7	302.3	0.0	382.0
Railroad Retirement	11.2	7.8	10.9	3.7	11.8
Unemployment Compensation	38.4	29.0	29.1	0.0	38.3
Federal Employee Retirement Programs					
Federal Civilian Retirement	294.7	63.4	35.6	0.0	322.5
Federal Military Retirement	102.7	37.7	25.6	0.0	114.8
Total: Trust Funds in the Proposed Income Replacement Budget	765.6	503.6	403.5	3.7	869.4

The establishment of a separate Income Replacement Budget will allow the financing of the programs included in this budget to be clearly identified. Using the OMB February 1992 estimates, these programs will show a surplus of $103.8 billion in Fiscal Year 1993. This surplus will be clearly shown in the Income Replacement Budget. The surplus or deficit in each Trust Fund and in general fund programs will be simply the difference between revenue and outlays. In contrast, under the current budget practices, the extent to which Trust Fund programs are self-financed is hidden, and the interest earned by these trust funds on mandatory investments in government securities is not included in the budget totals. Under the Restructured Budget, the true interest obligation of the Federal government would be shown in the operating budget, and the extent to which the Income Replacement trust funds are self-financed would be clearly shown in the Income Replacement Budget.

SECTION IV. OPERATING BUDGET

The totals for the operating budget will show three costs that are now hidden by the current budget structure. These include:

- Interest on trust fund investments in the Income Replacement Budget, which are estimated to be $68.5 billion in Fiscal Year 1993.

- Government Contributions As An Employer to Income Replacement programs, which are estimated to be $34.9 billion in Fiscal Year 1993.

- Government Contributions from general funds to finance Income Replacement programs.

These three items add about $146 billion to the operating budget. The operating budget excludes outlays which are allocated to the Capital Investment Budget ($169.4 billion in Fiscal Year 1993 based on the February 1992 OMB estimates) and to the Income Replacement Budget ($417.4 billion based on the Summer 1993 CBO estimate). These adjustments leave outlays of $1.1 trillion that is financed with about $0.8 trillion in general revenues and about $0.3 trillion in borrowing.

The operating budget will reflect spending which is current consumption; and will include all government spending which is currently on-budget which has not been specifically identified for inclusion in either the Capital or Income Replacement Budgets.

SECTION V. SUMMARY

The net impact of the proposed restructuring is shown in Table VA, which summarizes the current and proposed budgets, and Table VB, which gives a functional breakdown.

Table VA
Illustrative Breakdown of Budget Estimates For Fiscal Year 1993
Based on the Budget Restructuring Proposal
(in billions of dollars)

	Current Unified Budget	Capital Investment Budget	Income Replacement Budget	Operating Budget
RECEIPTS/REVENUES				
Income, Estate, Gift, Customs Duties	648.5	0.0	0.0	648.5
Social Insurance, Taxes, and Contributions	446.8	0.0	360.3	86.5
Excise Taxes and Miscellaneous Receipts	68.8	25.0	0.7	43.1
Interest on Trust Fund Investments	N/A*	2.7	65.8	0.0
General Fund Contributions To Income Replacement Budgets	N/A*	0.0	42.6	0.0
Government Contribution As Employer To Income Replacement Budget	N/A*	0.0	34.9	0.0
TOTAL RECEIPTS	1164.0	27.7	504.3	778.1
TOTAL OUTLAYS	1516.7			
ALLOCATION OF CURRENT OUTLAYS	1516.7	169.4	417.4	929.9
ADDITIONS TO OUTLAYS IN CURRENT PRESENTATION				
Interest on Trust Fund Investments				68.5
General Fund Contributions To Income Replacement Budget				42.6
Government Contribution As Employer To Income Replacement Budget				34.9
TOTAL OUTLAYS	1516.7	169.4	417.4	1,075.9
DEFICIT (-) SURPLUS (+)	-352.7	-141.7	86.9	-297.8

*Note: * Indicates funding that is currently netted out in the unified budget totals.*

48

Table VB Preliminary Functional Breakdown of Budget Estimates For Fiscal Year 1993 Based on Budget Restructuring Proposal With All Capital Options Included (in billions of dollars) .				
	Current Unified Budget	Capital Investment Budget	Income Replacement Budget	Operating Budget
Defense/International (050/150)	314.2	51.3	0.0	262.9
Science, Space, and Technology (250)	17.0	10.1	0.0	6.9
Energy, Natural Resources, Agriculture (270, 300, 350)	40.8	26.7	0.0	14.1
Commerce and Housing Credit (370)	63.6	0.0	0.0	63.6
Transportation (400)	35.1	22.9	0.5	11.7
Education, Training, Employment, and Social Services (500)	49.6	36.2	0.0	13.4
Health and Medicare (550, 570)	237.5	11.4	0.1	226.0
Income Security (600)	197.3	0.0	96.5	100.8
Social Security (650)	302.3	0.0	302.3	0.0
Veterans Benefits and Services (700)	34.3	1.2	12.6	20.5
Other (450, 750, 800, 870, 920)	52.0	9.6	5.4	37.0
Interest (900)	214.6	0.0	0.0	283.1
Total: Undistributed Offsetting Receipts (950)	-41.6	0.0	0.0	-6.7
General Fund Contributions To Income Replacement Budget	N/A	0.0	0.0	42.6
Total Outlays	1516.7	169.4	417.4	1075.9

Tables VA and VB show the contribution of each of the three trust funds to the overall consolidated budget deficit of $352.7 billion.

- Not surprisingly, the largest contributor to the deficit is the operating budget which accounts for 84 percent of the projected deficit. Table VB shows that

Interest payments ($283.1 billion) are the largest single expenditure followed by defense and international ($262.9 billion). These two account for 51 percent of spending in the operating budget.

- The Capital Investment Budget (CIB) also runs a deficit, but this deficit is less than half of the deficit in the Operating Budget. In addition, this deficit is calculated like the current budget on a cash, not an accrual basis. In fact, the deficit in the CIB would be substantially less if the Federal government in fact did budgeting like the private sector.

- The Income Replacement Budget operates at a surplus of $86.9 billion. About half of this surplus in fact would vanish if the Federal government did not make general fund contributions to specific Income Replacement programs of $42.6 billion in addition to the mandatory payments which it makes for interest and to fulfill its responsibility as an employer. Examination of these payments as a way to reduce the Operating Budget deficit would not be precluded under this proposal.

In conclusion, this restructuring proposal represents a start toward a reorientation of the budget debate toward separating government consumption from public investment. It also would make clear the extent to which the current budgetary practices use trust fund surpluses as a way to mask the deficit in the operating part of the budget.

Ms. CHAMBERS. Thank you.

The Federal budget was last balanced in 1969, which is ironically, the same year the unified budget was put into place.

Mr. CONYERS. Is there a connection between those two?

Ms. CHAMBERS. One could draw a connection. I don't think I will go that far.

In fact, over the course of the 24 years the unified budget has been in place, it has become an increasingly poor measure of the role of the government in the economy and of the deficit itself.

At the time that the unified budget was put in place, we had a pay-as-you-go system for our trust funds. We didn't have large surpluses. In the 1980's, we made decisions to build surpluses in the Social Security trust funds and the Federal employee retirement trust funds. Those surpluses are now used in the unified budget to mask a considerable portion of deficit spending. Over $100 billion of current spending is masked in the deficit figures because we are counting the surpluses in trust funds against total outlays.

We have now created a situation where we borrow from trust funds to finance additional deficit spending. But because of the way the unified budget is set up, the interest that the government then owes on those trust funds does not show up in the budget.

Not only are we masking the size of the deficit but we do not report the interest that we then pay on the borrowing that is used to mask the deficit. In fiscal year 1998, over $120 billion in interest will not appear on the bottom line of the budget that will be the interest paid to trust funds.

We hide expenditures in the budget in other ways as well. I think it is very important to identify these because if we are going to do budget restructuring, such as instituting a capital budget, we need to look at all the problems with the current unified budget structure and make corrections where it is feasible and where it fits into the overall scheme of budget improvement.

If you look at the total outlay figures in the fiscal year 1994 budget that the President sent up in April 1993, it identifies $1.5 trillion in outlays. That figure is an understatement of the total outlays of the Federal Government. The government will actually outlay $2.1 trillion in fiscal year 1994 under the policies in that budget.

Now where did the $600 billion go? It is not a matter of cooking the books. It is simply the conventions of the unified budget where we bring in receipts and fees, offsetting collections of various kinds, and we net those specifically against appropriated accounts so that they never appear in the bottom line of the budget. Thus we make spending appear smaller than it actually is.

Now it is interesting that most of those fees occur in areas of the budget that then do not get as much scrutiny as the social program areas which everyone seems to want to focus on when one is looking at a deficit reduction. These fees include things like National Park Service, waterway user fees, and grazing fees, when the various kinds of fees are brought into the Federal budget they now are brought in as negative outlays. We subtract those from positive outlays so we get a lower outlay figure.

On page 8 of the prepared statement, a chart identifies all the areas of the budget outlays. I will not go on with this point since

I know we are constrained for time, but my testimony goes into some detail in all of these areas.

While I would not recommend that we end the practice of associating fees with the programs that they finance. I do believe that it is very important that when we look at the total level of government activity and the percentage of division of our resources among areas, that we should include these outlays financed with fees in that discussion.

We would have a very different view of what the Federal Government is doing. We would see much more clearly how we have underinvested in infrastructure, how we do not basically invest for the future in our budget. Because of the way we structure the budget, decisionmakers in allocating government resources do not have the tools that they need in order to make investment decisions.

For that reason, Dr. Rotherham and I developed this very extensive budget restructuring proposal. It sets up a capital budget. It includes capital facilities, facilities for infrastructure, whether Federal infrastructure or State and local infrastructure that the Federal Government finances, and research and development [R&D].

We would also include education and training in our capital investment budget. We looked at other human capital programs. The dilemma is that while several viewed in isolation could be worthy candidates collectively, they would constitute a precedent that would open up many more programs for inclusions. Therefore, we would include in the capital budget only education and training, basically, subfunctions 501 through 505.

So we would see the capital budget as a presentation, as a tool for decisionmaking by the Congress that includes human capital activities as well as physical capital.

In addition, we would not recommend that depreciation be part of the capital budget, at least in the beginning. We believe depreciation estimates should be developed but that the capital budget should be on a cash basis in the budget just like the operating budget. Depreciation estimates should be developed at some later point when better data is available. A decision on whether it is appropriate to move the capital budget from a cash accounting to an accrued basis could be made then, but we do not believe there is adequate information on depreciation to incorporate depreciation schedules now.

By leaving the budget on a cash basis, control of the purse strings is maintained within the Congress. It also gives the ability to identify what level of investment and cash-flow is appropriate for investment.

The 37 States that have capital budgets do not depreciate generally because it is very hard to develop depreciation estimates for public capital.

In addition to establishing a capital budget, Dr. Rotherham and I would set up an income replacement budget. We would separate out Social Security, the Federal retirement programs, and unemployment insurance. These are programs that represent past commitments made to workers. They are income replacement. They are primarily trust funds and for the most part are financed with dedicated revenue. The major exception that we included veterans' com-

pensation, a general fund which is not program means tested but an income replacement retirement program.

We would include these programs separately. Unemployment insurance is a particularly important one to separate out. I think its treatment in the unified budget is completely inappropriate. We have a program that was instituted to build up surpluses in good times and to spend those surpluses down, thereby creating annual deficits in that program in recessionary periods. We have turned that program on its head.

Under the current budget rules, even spending for unemployment insurance must be deficit neutral in a recession, so we cannot use the surpluses that have been built up in the past in the recession for which they were intended. It is very important to move that program out, I think and also to account separately for retirement programs—Social Security, and the Federal employee retirement programs.

That leaves everything else in an operating budget. If one were to look at bringing greater balance between revenues and spending, one would look at the operating portion of the budget. The retirement portion of the budget would have large surpluses. In the capital portion of the budget, we would have deficits. But those would be deficits that are building for the long term. It is the operating budget that then one should look toward to bring greater fiscal control over the deficits.

On page 29 of my written statement, I think, there is a chart that shows the three budgets. Yes, it is. Page 29 shows how we have taken all the programs in the budget and put them into one budget or another. On a consolidated basis, you would still have the same total deficit, but you identify where that deficit and where the surpluses come from. That will enable decisionmakers to make better fiscal policy decisions and, will result in increased investment spending and decreased spending for consumption, which is really the bottom line of where I think we need to go. But you cannot expect Congressmen and Senators to be able to make those decisions, if they do not have a budgetary presentation that lays it out so they know where the programs for investment and consumption are at the current time.

[The prepared statement of Ms. Chambers follows:]

November 8, 1993

Testimony of Letitia Chambers
President, Chambers Associates Incorporated
Before the Legislation and National Security Subcommittees
Committee on Government Operations
U.S. House of Representatives
November 9, 1993

Mr. Chairman, I am president of Chambers Associates Incorporated, a public policy consulting firm that specializes in tax and fiscal policy issues. I am appearing today as an individual and not on behalf of any client of the firm. My testimony is based partially on a paper[1] that I co-authored with Dr. Jim Rotherham, who is a colleague at Chambers Associates and a former senior staff member of the House Committee on the Budget.

WHY THE CURRENT BUDGET STRUCTURE IS OBSOLETE

The last time the Federal budget showed a surplus was Fiscal Year 1969, ironically, the same year the Johnson administration instituted the current unified budget structure. Over the past 24 years during which the unified budget has been in effect, the United States has had the longest period of sustained budget deficits in its history. Over this period, the unified budget structure has become an increasingly poor measure of the deficit and grown increasingly irrelevant to a serious debate about the role of the Federal government in the economy.

---

[1] Letitia Chambers and James A. Rotherham, "Restructuring the Federal Budget" (April 1993).

2

The current budget structure understates the extent to which general revenues fail to cover the cost of government. Under the unified budget concept, all revenues are arrayed on one side of the ledger, and all spending is arrayed on the other side. All revenues earmarked by statute to support a specific activity, including trust fund revenue, are pooled with general revenues, and all spending is also pooled, regardless of how it is financed. The difference between total revenue and total spending determines whether the budget is in balance, surplus, or deficit. Thus, under the unified budget[2] the current surplus in the trust fund component of the budget masks part of the deficit in the general fund component of the budget. In Fiscal Year 1994, the trust funds will mask over $100 billion in general fund deficit spending[3], as shown in Table 1. Trust fund surpluses now hide more than one fourth of the deficit. (28 percent in the OMB April 1993 estimates for Fiscal Year 1994.)

What constitutes spending in the unified budget is also often misleading. The treatment of interest is a good example. When trust funds were brought into the budget in 1969, transactions between general funds and the trust funds were eliminated from the budget totals. At that time, trust funds were financed essentially on a pay-as-you-go basis. In the early 1980's, Congress put both Social Security and

---

[2] Congress excluded Social Security from the unified budget by law, but OMB and CBO get around this change by continuing to include Social Security in the budget and calling it the consolidated budget.

[3] For purposes of consistency, all budget numbers use the Administration's April 1993 estimates. This is the most recent OMB estimate that provides a breakdown of trust fund and non-trust fund spending.

Federal civilian and military employee retirement programs on a partially forward funded basis by setting aside funds to finance part of future retirement costs. This

Table 1
Surplus or Deficit by Fund Group
Fiscal Year 1994 President's Budget
(in billions of dollars)

Surplus (+) / Deficit (-)	
General Funds	-367.4
Trust Funds	+103.4
Consolidated Deficit	-264.1

Source: OMB, The Budget For Fiscal Year 1994, (April 1993), p. 22.

partial forward funding policy has created far larger trust fund balances. These balances are invested in Treasury securities, and the government owes interest on these securities to the Trust Funds. Since interest paid to trust funds is not counted in outlays, the result has been a large exclusion from the budget totals of the cost of paying interest on the national debt.

In just a few years, Social Security will no longer be the largest program. By fiscal year 1998, spending for interest on the public debt will be more than Social Security spending -- $393 billion is the projected payment for interest on the public debt in 1998 while spending for Social Security is projected at $384 billion. The interest number that is a building block in arriving at total spending in the unified budget, however, is not interest on the public debt. Instead, it is a net number which subtracts out interest that the Federal government pays to trust funds. The interest

that will be subtracted out of the budgetary totals in the unified budget in 1998 is estimated to be $120 billion. The interest owed to trust funds will continue to grow if the current policy to advance fund retirement remains in place. Therefore, even larger levels of government obligations to pay interest will be hidden in the future by the unified budget.

Table 2 shows the difference between the total interest obligations of the United States and the actual interest spending included in the bottom line of the Federal budget.

Table 2
Interest Outlays Projected for Fiscal Year 1998
(OMB April 1993 Estimate)

(in billions of dollars)	
Interest on the Public Debt	392.5
Interest received by on-budget trust funds	-64.4
Interest received by Social Security trust funds (OASDI)	-46.7
Interest received by other Government entities	-9.1
Interest Subtracted from total for interest on the public debt	**-120.2**
Net Interest payment included in the bottom line of the Federal budget	**272.3**

Source: OMB, The Budget For Fiscal Year 1994, (April 1993), Appendix p. 31.

Mr. Chairman, under the current accounting methods of the unified budget, we use trust fund surpluses to hide or mask the true level of deficit spending in the general fund, and once these surpluses have been borrowed to pay for current government operation deficits, we don't count the interest owed on the funds borrowed. If a business didn't include a major debt in its statement of assets and

liabilities, and if it didn't count in its expenditure totals the interest it paid on a loan, we would call it fraud.

THE CURRENT BUDGET STRUCTURE UNDERSTATES SPENDING

In April 1993, OMB released a budget for Fiscal Year 1994 that proposed total outlays of $1.5 trillion. In fact, total outlays in Fiscal Year 1994 will be $2.1 trillion. Did OMB cook the books? No, all OMB did was to follow the accounting conventions proposed nearly a quarter of a century ago by the President's Commission on Budget Concepts. The missing $600 billion is offsetting collections of various kinds.[4]

OMB defines offsetting collections as:

> "[C]ollections from the public that result from business-type or market-oriented activities and collections from other Government accounts. These collections are deducted from gross disbursements in calculating outlays, rather than counted in Government receipt totals."[5]

---

[4] The type of spending in this analysis is obligations, which is a binding agreement for the Federal government to spend money. The authority to spend is given by Congress in the form of budget authority. The actual commitment of funds is an obligation. When the payment is actually made, it is an outlay. Outlays are the type of spending measured against revenue to determine whether the budget is in balance, surplus, or deficit. Traditionally, the analysis that provides detailed estimates on the various types of offsetting collections is issued after the President's budget is released. This analysis uses obligations. The document is the Object Class Analysis. See: U.S., OMB, Budget Review and Concepts Division, Budget Concepts Branch, Object Class Analysis: Budget of the United States Government for Fiscal Year 1994 (April 1993). Hereinafter cited as OMB, FY 1994 Object Class Analysis.

[5] OMB, FY 1994 Budget, Appendix, p. 1273.

6

The offsetting collections for Fiscal Year 1994 are shown in Table 3 by branch of government. Also shown are the offsetting collections that OMB does not distribute by department or agency.

The four categories of collections are as follows:

- **Payments by the Public That Finance Increased Spending** -- These payments, for which the technical name is "offsetting collections from the public," will reduce obligations $166 billion in Fiscal Year 1994. These payments by the public automatically finance spending totals without any appropriations action. These are typically user fees, such as entrance fees to National parks.
- **Payments by the Public That Mask Spending** -- These payments, for which the technical name is "proprietary receipts," will reduce obligations by $48 billion in Fiscal Year 1994. These are fees that are placed in separate accounts. These accounts reduce total spending for the agency that collects them but are not automatically available to finance spending. Before these payments can be used to finance additional spending, the Congress must approve their appropriation to the spending account. Proprietary receipts are typically payments from business-like transactions with the public or with other governments.
- **Transfers from the General Fund That Finance Increased Spending** -- These payments are transfers for specific purposes, such as the general

fund payments to partially finance Corps of Engineers' program.[6] Such payments, which must have prior Congressional approval, automatically finance spending. These payments will be $172.8 billion in Fiscal Year 1994.

- **Other Transfers** -- This category includes other intragovernmental financial transactions. Overall, this category reduces spending by $238.2 billion. The largest category is undistributed offsetting receipts, which are deductions made from overall spending before spending totals for agencies are calculated. The largest items of offsetting receipts are: interest received by trust funds ($86.1 billion) and the Federal government share as an employer for employee retirement ($34.8).

Table 3 summarizes these adjustments. A more detailed table is included in Appendix Table 1 to this testimony. Mr. Chairman, these tables and their descriptions are taken from a research project which Chambers Associates currently has underway for the National Committee to Preserve Social Security and Medicare.

Payments made by the public which finance spending, which are shown in the second and third columns of Appendix Table I, are brought into the budget as negative outlays that are subtracted from other outlays. For example, the fee collected as a water way user charge is not treated as revenue on the income side of the ledger. Instead the total of fees collected for this purpose, and the outlay figure shown in the

---

6 Corps of Engineers gross outlays will be $1.537 billion in fiscal year 1994. The net outlays, however, will be $1.155 billion. The difference, $0.382 billion, is $0.260 billion in transfer from the general fund and $0.122 from trust funds.

budget is net of this subtraction. While there is a clear justification in the budget for associating a fee collected to the service it is related to, the current treatment makes it look as if total government outlays are significantly lower than is the case.

Table 3
Federal Obligations
Before and After Offsetting Collections and General Fund Subsidies
Fiscal Year 1994 (April 1993)
(in billions of dollars)

	Gross Obligations	Payments by the Public That Finance Increased Spending	Payments by the Public That Mask Spending	Transfers from the General Fund That Finance Increased Spending	Other Transfers	Net Obligations
Total for Government	2,146.9	(166.2)	(48.4)	(172.8)	(238.2)	1,521.3
Executive Branch	2,139.2	(166.1)	(48.4)	(171.7)	(113.5)	1,639.5
Legislative Branch	4.3	(0.1)		(1.0)		3.1
The Judiciary	3.5		0.0	(0.1)	(0.1)	3.2
Undistributed Offsetting Collections	0.0	0.0	(0.0)	0.0	(124.5)	.0
Interest received by trust funds	0.0	0.0	0.0	0.0	(86.1)	(86.1)
Proprietary Receipts	0.0	0.0	(0.0)	0.0	(3.6)	(3.6)
Employer Share, employee retirement	0.0	0.0	0.0	0.0	(34.8)	(34.8)

Public Enterprise Funds

Offsetting collections also are used to finance public enterprise funds. These are market-oriented activities conducted primarily with the public. Public enterprise activities are financed with offsetting collections. OMB does not include in the President's Budget a list of spending for the public enterprise funds, although OMB identifies them in a separate analysis that is released after the budget is released. This is an unfortunate omission because the budget treatment of public enterprise funds gives these funds a significant advantage over programs with conventional budget accounting. For public enterprise funds, government subsidies from general funds are

deducted from the spending total for the program just like user fees or other payments from the public.

Ironically, the major exception to this budget procedure for offsetting collections is the premium for the Supplementary Medical Insurance (SMI) program (Part B of Medicare). As a health insurance program in which participation is voluntary, Part B of Medicare clearly qualifies as a business-type activity. It is not accorded the accounting procedure for public enterprise funds, however, and the budget keeps the premium income separate from the Medicare spending. Most likely, the motivation is that if Part B of Medicare were actually treated as a public enterprise fund and all of the collections, including both the premium and the payment from the general fund were subtracted from gross spending, the program would look as if it were almost breaking even. Table 4 shows the current budget treatment of SMI and what the spending would be if it were a public enterprise fund.

Table 4
Current Budget Presentation and Public Enterprise Fund Treatment of Supplementary Medical Insurance Fund
Fiscal Year 1994 Clinton Budget Proposal Under Current Law
(In billions of dollars)

	CURRENT BUDGET PRESENTATION		PUBLIC ENTERPRISE FUND TREATMENT	
	OUTLAYS	RECEIPTS	OUTLAYS	RECEIPTS
Gross Outlays	64.3	na	64.3	na
Interest on Federal securities	na	1.5	-1.5	na
Federal Contribution	na	45.1	-45.1	na
SMI Premium	na	16.7	-16.7	na
Total	64.3	63.3	1.0	na

Source: Authors' calculations based on OMB, FY 1994 Budget, Appendix, P. 621

With a public presentation of the Supplementary Medical Insurance program that follows the budgetary convention utilized for all other programs which collect fees, spending for this program falls from $64.3 billion to $1.0 billion, but the overall budget deficit is not affected by a penny.

This example illustrates how arbitrary Federal budgeting can be and that there is some budgetary opportunism in how definitions are applied. On the other hand, the way the budget is structured has a significant impact on how programs are viewed. Obviously a $64 billion program concerns policy makers more than a $1 billion program.

This truism may explain why some programs get far more attention than others. For example, the Department of Agriculture under the President's Fiscal Year 1994 budget will spend $87.05 billion in Fiscal Year 1994. The net spending that appears in the budget will be 29 percent lower than that figure, or $61.9 billion.[7]

The budget as currently structured does not consolidate the payments made from the general fund to public enterprise funds. Thus, subsidies to activities such as the Commodity Credit Corporation, Land and Water Conservation, and Foreign Military sales are effectively hidden from public scrutiny; indeed, the extent of such subsidies is unknown except to a few budget specialists who work on the specific programs. What happens, however, under the unified budget accounting procedures is that the spending for these programs appears smaller than it actually is, which in turn makes

---

[7] OMB, FY 1994 Object Class Analysis, p. 95.

the spending levels for programs that do not get this favored treatment appear relatively larger.

Another area in which the government costs may be understated in the budget is for fees in which the government charges less than the market price. At least in the Medicare program, the government explicitly makes up the difference from general funds between the actual cost of the Part B coverage and what is charged in premiums, and this subsidy appears in the budget. There are many examples of fees that are below the market price where the loss to the government is not shown in the budget. This may be an area for inclusion in a restructured budget. I would caution, however, that this is an area, like depreciation, which is discussed later in my testimony, in which we could find ourself drowned in accounting concepts and fail to keep our eye on what should be the goal of a budget document: to facilitate informed debate on how much money to collect from the public and how to distribute the money that is collected.

OTHER STRUCTURAL PROBLEMS WITH CURRENT BUDGET

The current budget structure understates the scope of government activities. The range of government activities is far broader than simply spending and raising revenue. Special tax breaks, or tax expenditures, to achieve public objectives are analogous to government spending. The whole range of Federal activities -- spending, revenue, tax expenditures, and collection of fees -- must be factored into federal decision making on budgetary issues. The manner in which they are presented (or not

presented) in the Federal budget influences decision making and affects the quality of the decisions.

The budget process is preoccupied with the short-term. The Federal budget primarily focusses on the pending fiscal year. This leads to many short-sighted decisions designed to keep immediate spending down even at the expense of higher spending in future years.

The current budget structure shortchanges Domestic Infrastructure investment. Federal non-Defense infrastructure investment was slightly more than 1.0 of GDP during the 1960's and 1970's. Between the 60's and the 70's, the deficit more than tripled as a percentage of GDP. During the 1980's, the deficit as a percentage of GDP nearly doubled from the rate for the previous decade, while infrastructure investment declined as a percentage of GDP. Impediments to adequate funding for infrastructure investment are:

(1) The lack of a capital budget. The current cash-based procedures front load the costs, include no depreciation allowance for direct Federal investment, and fail to identify programs that represent investments for the future.

(2) The failure to identify in the budget the extent to which infrastructure investment is financed with dedicated revenue.

The current budget structure gives the misleading impression that current spending on entitlements is spiraling out of control. The truth of this premise is not self-evident.

- From 1975 to 1991, entitlement spending was not significantly different either as a percentage of total Federal spending or as a percentage of Gross Domestic Product. It declined as a percentage of total spending from 49.5 to 48.0 percent over this period. As a percentage of GDP, it increased only from 10.9 to 11.3 percent.
- During the decade from 1981 to 1991, gross entitlement spending declined slightly both as a percentage of the Federal budget and as a percentage of Gross Domestic Product.
- When overall entitlement spending is adjusted to reflect dedicated revenue used to finance it, general fund entitlement spending as a percentage of GDP declined from 5.3 to 4.3 percent between 1981 and 1991.
- Most categories of entitlement spending have been either stable or have declined over the past decade. The exception is spending for the two major health entitlement programs -- Medicare and Medicaid. The rapid rate of growth for these health programs during the 1980's is part of the growth in all health care spending. The health care system needs reform, but if the changes are made simply in the context of Federal deficit reduction, the political system could simply shift health care costs from the Federal government to providers, employers, or consumers.

The Federal budget is not equipped to deal with structural or counter cyclical economic problems. Beginning with the Carter Administration and during each succeeding administration, macroeconomic and economic growth considerations have been subordinated to efforts to restrain the Federal deficit.

An example of how the budget structure works at cross purposes with counter-cyclical policies is the unemployment compensation program. The notion that an extension of unemployment benefits in a recession must be deficit- neutral in the Federal budget turns the traditional approach to financing this system upside down. The original goal of the unemployment insurance program was to run surpluses in good times and deficits in hard times, with surpluses rebuilt in the following recovery. The budget process holds the trust funds to a new standard -- unemployment insurance should be deficit-neutral even during periods of high unemployment, and even surpluses in the Trust Funds cannot be used for their intended purpose. The use of a counter-cyclical program to reduce the Federal deficit shifts the burden of budgetary restraint to innocent victims -- the unemployed. The fact that the program is financed primarily with state taxes, which are held on deposit by the federal government, makes this situation even more appalling.

We effectively have abandoned using the fiscal tools of the Federal government to affect the economy, while three Presidential administrations have been unable to control the deficit. The Clinton administration has started to get a handle on this issue, but quite frankly after less than a year in office, we cannot predict whether it will be successful.

Mr. Chairman, the current budget structure reflects a series of arbitrary decisions, which were made 25 years ago and which are no longer appropriate given policy changes made since that time. It is no longer relevant to the issues which the United States faces as the 20th century draws to a close, and in fact, the budget structure itself has become a hindrance to sound fiscal policy making.

PROPOSED BUDGET RESTRUCTURING

My colleague, Dr. Rotherham, and I have developed an alternative budget structure which was specifically designed to eliminate the obfuscation inherent in the current structure so that Congress would have the information it needs to evaluate and make budgetary decisions. The budget structure we propose would allow policy makers to distinguish between consumption and investment decisions, which we believe to be a vast improvement over current practices. Our proposal also is designed to make clear to decision makers the true scope and the nature of federal spending. To accomplish this goal, the unified budget should be divided into three discrete budgets:

- A Capital Investment Budget which reflects investments for the future and includes expenditures for programs and activities which have multiple-year life and raise future productivity.
- An Income Replacement Budget, which reflects the nation's past commitments made to workers which are in part advance funded by the

workers and their employers including Social Security, Federal Employee Retirement programs, and the Unemployment Insurance System. .

- An Operating Budget which contains all other programs and activities and reflects **current consumption** by the federal government.

CAPITAL BUDGET

The capital budget that we propose draws from the extensive analysis of the Government Accounting Office (GAO). The Vice President's National Performance Review endorsed a capital budget. Our approach differs somewhat from the General Accounting Office's latest published report on of budget restructuring which would create four budgets: general, trust, enterprise, and investment. Each of these four budgets would have an operating and capital component. While this concept is interesting, it is very complex and amounts to the substitution for one unified budget of eight separate budgets. For that reason, we do not recommend adoption of the GAO model, although there are many similarities between this proposal and the GAO model.[8]

---

[8] The formal GAO proposal is included in: U.S., General Accounting Office, Managing The Cost of Government: Proposals For Reforming Federal Budgeting Practices, GAO/AFMD-90-1 (October 1989). Current GAO thinking on this issue is contained in a September 1992 discussion memorandum that has been circulated to a small number of academics. The most recent public GAO position was included in the testimony of Paul L. Posner, Director of Budget Issues, Accounting and Financial Management Division, General Accounting Office, before the Subcommittee on Legislation and National Security, Committee on Government Operations, U.S. House of Representatives (July 23, 1992).

The Capital Investment Budget proposed will report both capital revenues and capital investments. Capital revenues include all taxes which are earmarked by law to finance specific capital investments. Capital revenues also include principal repayments and interest paid by the Treasury on securities held by capital trust funds.

Capital investments also include the subsidy cost of loans which increase investment. This is consistent with the credit reform enacted by the Congress in 1990 and is the treatment currently recommended by the GAO.

There are compelling reasons to enact a capital budget. First, capital budgeting would enable policy makers to quantify the commonly-held belief that public investment is a worthwhile activity, and would identify the level of federal investment. The Congressional Budget Office has concluded that "carefully chosen federal investments in physical infrastructure such as highway and aviation projects would yield economic rates of return higher than the average return on private capital."[9]

At least 37 states have recognized the value of a capital budget, and have a capital budget either as a part of their overall budget or as a separate budget.[10] There is not, however, one state model that can be easily applied to a federal capital budget. State capital budgeting practices differ markedly among each other and also from private sector accounting practices. Typically, long-term debt instruments and dedicated revenue sources, particularly user fees, finance State capital budgets. The

---

[9] U.S., Congressional Budget Office, How Federal Spending for Infrastructure and Other Public Investments Affects the Economy (July 1991), p. xv.

[10] U.S., General Accounting Office, Managing The Cost of Government: Proposals For Reforming Federal Budgeting Practices, GAO/AFMD-90-1 (October 1989), p. 11.

operating portion of State budgets, including the cost of servicing the debt of the capital budget (but excluding capital expenditures), is the part of a State's budget that is typically subject to statutory or state constitutional balanced budget requirements. An important distinction between the proposed Federal capital budget and State and local government capital budgets is that the Federal capital budget would be a vehicle to facilitate decisions on the appropriate level of public investment, while State and local capital budgets primarily reflect financing mechanisms.

A capital budget would allow consumption spending to be distinguished from capital spending. The former does not increase productivity, while the latter has the potential to. From that premise, it follows that capital outlays may be less harmful in terms of the deficit than consumption outlays.[11]

An important advantage of a capital budget is that it smoothes expenditures and thus eliminates swings in taxation necessary to finance investment. This argument has more validity for State and local budgets than for the Federal budget, since the size of the Federal budget makes it unlikely that specific projects would have a significant impact on total spending in any given year. On the other hand, the so-called lumpiness of capital spending creates problems because of our Byzantine budget process. Now discretionary capital and consumption spending are forced to complete against each other within the discretionary cap. Under our proposals, separate caps for consumption spending and for investment discretionary spending could be established.

---

[11] The GAO makes this distinction. See: GAO, Managing The Cost of Government, p. 11.

EDUCATION AS HUMAN CAPITAL INVESTMENT

Mr. Chairman, you also asked that I comment on the merits of providing capital treatment for Federal investments in human capital. As you know, this is a difficult issue, particularly for those of us who care deeply about human resources programs. If state practice is a guide, none would be included. A recent survey of state practice concluded that intangible capital, such as investment in "human" or "intellectual" capital is not included in any state capital budgets.[12]

On the other hand, the General Accounting Office (GAO) notes that many private sector researchers consider many human resource programs as an investment. In particular, most researchers would categorize spending for education and training programs as an investment.[13] On programmatic grounds, however, there is a basis for a distinction between federal and state budgetary treatment of education as an investment. State and local governments finance most public education in the United States. The Federal government funds elementary and secondary education essentially for two purposes:

(1) to provide seed money for innovation, and

(2) to reduce funding disparities because of differing state and local tax bases as well as concentrations of disadvantaged students with greater educational needs in certain communities and states.

---

12 Henry Thomassen, "Capital Budgeting for a State," Public Budgeting and Finance, Vol. 10, Number 4 (Winter 1990), pp. 72-73.

13 U.S., General Accounting Office, Human Resource Programs Warranting Consideration As Human Capital, GAO/AFMD-90-52, p. 4.

Clearly, the first purpose is a form of investment. The second is essentially based on the assumption that there is a national interest in providing adequate educational opportunities for all jurisdictions, regardless of their taxing ability and the number of students with special needs. This, too, could be justified as a form of public investment. Appendix Table 2 summarizes Fiscal Year 1994 capital spending which we propose be included in the capital budget while Appendix Table 3 provides the outlays for education and training programs which we would propose be included in a capital budget.

There are significant conceptual and measurement problems if human resource programs (whether education and training or others) are included in a capital budget. The first issue is calculation of rate of return. Particularly, where the Federal investment is only part of the cost, this poses significant methodological problems. The second problem would be how to separate the investment and consumption components of these programs.

OTHER HUMAN CAPITAL INVESTMENT

Other programs and activities which promote the health and well being of individuals could be characterized as "investing" in their further productivity. Taken to its extreme, any program which provides food, health services, housing, or income with which to purchase such products and services could be identified as human capital programs. While this may be a useful and legitimate construct for some purposes, too inclusive a capital budget would make the concept meaningless.

Therefore, I believe basic health and social programs should be excluded from the capital budget.

There are a few programs, however, for which a strong case for inclusion could be made. These options are set forth in Appendix Table 4. Considered in isolation, each program in Table 4 is defensible as an investment. On the other hand, inclusion of each makes it more difficult to make distinctions from other programs which are not included. Therefore, we recommend that these programs as well as other health and social programs be excluded from a capital budget.

There could be substantial political pressure from congressional authorizing committees and from interest groups to include their favored programs in the capital budget, under the presumption that inclusion might make a program immune from cuts and garner support for increased funding. Such a presumption would be false if the programs in the capital budget are assessed in terms of rate of return, which is the criteria used in the private sector in making investment decisions. Unfortunately, this criteria is seldom applied in Federal government investment decisions because meaningful rate of return estimates are seldom made. Using rate-of-return as a decision criteria becomes an incentive against inclusion in the capital budget of programs with mushy objectives and no way to assess effectiveness. On the other hand, in some areas such as basic research and development, rate of return estimates may be impossible to develop. The longer paper which I co-authored with Dr. Rotherham, and which I have made available to the Committee, recommends that

programs in the capital budget should be evaluated by rate of return criteria developed for that purpose.

Once a capital budget is put in place, a process should be created to screen any additional programs that may be proposed in the future for inclusion in the Capital Investment Budget. This could be accomplished by establishing an Advisory Committee consisting of the comptroller general, the director of the Congressional Budget Office, and the director of the Office of Technology Assessment to advise the President on recommendations for inclusion of new programs in the Capital Investment Budget. To avoid a constitutional challenge, this committee should be advisory only.[14]

INCOME REPLACEMENT BUDGET

In addition to the Capital Investment Budget, we propose creation of an Income Replacement Budget. Unlike the private sector, where businesses cannot include pension assets held on behalf of individuals, either in their assets or their bottom lines, the federal government places in its annual budget the surpluses from:

-- the pension systems provided for its own employees,

-- the Social Security system which provides a base retirement and disability program for all U.S. workers, and

---

[14] The constitutional issue is that the preparation of the President's budget is the responsibility of the Executive Branch, and these three officials are part of the Legislative Branch. The President cannot delegate executive responsibilities to the Congress.

-- the unemployment insurance system which collects a state tax from employers to provide benefits to unemployed workers while they look for jobs.

The programs proposed for inclusion in the Income Replacement Budget are financed through trust funds in which dedicated revenue is earmarked to finance benefits and administrative costs. (The exception is Veterans Compensation, which is financed with general revenues and functions as a form of disability and worker compensation program for former military personnel and their survivors. Benefits in Veterans compensation are tied to injuries, wounds, or death while in military service and are not means-tested.) No means-tested programs are proposed for inclusion in the Income Replacement Budget.

Social Security is the largest program in the Income Replacement Budget. Congress in three separate laws over the past decade has directed that Social Security be off-budget. This law has been honored more in the breach than in the observance. Placing Social Security in the new Income Replacement Budget has the advantage of keeping Social Security out of the operating budget, consistent with Congressional intent in taking Social Security off-budget.

Medicare is not proposed for inclusion in the Income Replacement program although it is part of the federal government's commitment to workers. Medicare does not increase the incomes of individual recipients by the amount of the health benefits they receive. If that were true, a terminally-ill individual would be counted as very wealthy. Thus, from that perspective, it is not an income replacement program. At

best, the income supplement is the insurance value of Medicare benefits. Medicare also is not structured to build up surpluses to advance fund benefits but is fundamentally a pay-as-you-go program.

The Unemployment Insurance program also would be included in the Income Replacement program. The way in which this obvious income replacement program is currently treated in the unified budget structure is inappropriate. It is primarily a State-administered program, and the revenues are from state taxes which are held in trust by the federal government. To subject State revenues to all of the arcane budget rules is a classic budgetary "Catch 22 maneuver" which has stalemated attempts to extend benefits during economic hard times, undercutting the fundamental purpose of unemployment compensation.

Outlays in the Income Replacement Budget are set forth in Appendix Table 5.

OPERATING BUDGET

The third budget is the Operating Budget, which reflects spending which is current consumption, and which includes all government spending which is currently on-budget which has not been specifically identified for inclusion in either the Capital or Income Replacement Budgets.

The totals for the Operating Budget will show three costs that are now hidden by the current budget structure. Based on Fiscal Year 1994 estimates, these include:

- Interest on borrowings from trust funds which we have placed in both the Capital Budget and the Income Replacement Budget, which are estimated to be $72.2 billion in Fiscal Year 1994;
- Government contributions as an employer to income replacement programs, which are estimated to be $26.6 billion in Fiscal Year 1994;
- Government contributions from general funds to finance Income Replacement programs.

These three items add $138.1 billion to the operating budget. The operating budget excludes outlays which are allocated to the Capital Investment Budget ($180.2 billion in Fiscal Year 1994 based on the April 1993 OMB estimates) and to the Income Replacement Budget ($425.4 billion). These adjustments leave outlays in the operating budget of about $1.05 trillion that is financed with about $700 billion in general revenues, about $150 billion in dedicated revenue, and $200 billion in borrowing.

SUMMARY

The net impact of the proposed restructuring is shown in Table 5, which summarizes the current and proposed budgets.[15]

Table 5 shows the contribution of each of the three budgets to the overall consolidated budget deficit, which remains the same, of $264.1 billion.

- Not surprisingly, the largest contributor to the deficit is the operating budget, which has a deficit of $196.8 billion even though all general

---

[15] Appendix Table 1 gives more detail on the breakdown of spending.

revenue is allocated to finance the operating budget. Interest payments ($309.6 billion) are the largest single expenditure followed by defense and international ($219 billion).[16] These account for half (50.4 percent) of the spending in the operating budget.

- The Capital Investment Budget also runs a deficit of $152.6 billion. This deficit is artificially inflated because no general revenue is allocated to the capital budget. In addition, this deficit is calculated like the current budget on a cash, not an accrual basis. In fact, the deficit in the capital budget would be substantially less if the Federal government in fact did capital budgeting like the private sector.
- The Income Replacement Budget operates at a surplus of $85.3 billion. This surplus would decline if the Federal government did not make general fund contributions to specific Income Replacement programs of $39.3 billion in addition to the mandatory payments which it makes for interest and to fulfill its responsibility as an employer. Examination of general fund contributions as a way to reduce the Operating Budget deficit would not be precluded under this proposal, and in fact general fund subsidies would be easier to identify and evaluate.

---

16 The interest amount is gross interest on the public debt. The defense/international outlays estimate excludes military retirement ($26.8 billion), which would be moved to the income replacement budget and DOD direct investment ($8.5 billion); and DOD research and development ($41.6 billion), which would be moved to the Capital Budget.

This restructuring proposal also would reorient the budget debate, separating public investment from government consumption. It also allows decisions on financing of capital expenditures to be specifically addressed. For any given capital expenditure, Congress will have to determine whether it should be financed:

- by dedicated revenues,
- by designating a share of general revenues that otherwise would have gone to the general fund, or
- by borrowing.

The appropriate financing method will depend upon the type of investment. For instance, highway construction may be financed as it is now, through a dedicated gasoline tax, which would go directly to the capital budget. Capital expenditure for a military installation might be financed by designating a share of annual general revenue to go to the capital budget rather than to the operating budget, on the rationale that such an expenditure should be considered as directly and immediately related to a fundamental purpose of the federal government, in this case to provide for the national defense. A decision of an appropriate share of general revenue to be designated to the capital budget would need to be made at the time the capital budget is established and reviewed based on policy decisions with regard to capital expenditures.

Borrowing is a well established financial practice which may be the most prudent way to finance some investments. Just as you or I might consider it wise to borrow to finance a house, but foolish to borrow to finance a vacation, the federal

government should separate its decisions on borrowing for investment from decisions to borrow to finance current consumption.

Illustrative Restructured Budget

Table 5 compares the aggregate numbers for revenue and spending in the current budget presentation and in the proposed budget restructuring. The estimates are based on revenue and spending in the Clinton Fiscal Year 1994 budget.

Table 5
Illustrative Breakdown of Budget Estimates for Fiscal Year 1994
Based on Budget Restructuring Proposal
(in billions of dollars)

	Current Unified Budget	Capital Investment Budget	Income Replacement Budget	Operating Budget
(in billions of dollars)				
RECEIPTS/REVENUES				
Income, Estate, Gift, Customs Duties	714.3			714.3
Social Insurance, Taxes, and Contributions	465.0		374.2	90.8
Excise Taxes and Miscellaneous Receipts	72.0	25.4	0.6	46.0
Interest on Trust Fund Investments	NA*	2 2	70.0	
General Fund Contributions To Income Replacement Budgets	NA*		39.3	
Government Contribution As Employer to Income Replacement Budget	NA*		26.6	
TOTAL RECEIPTS	1251.3	27.6	510.7	851.1
TOTAL OUTLAYS	1515.4			
ALLOCATION OF CURRENT OUTLAYS	1515.4	180.2	425.4	909.8
ADDITIONS TO OUTLAYS IN CURRENT PRESENTATION				
Interest on Trust Fund Investments				72.2
General Fund Contributions To Income Replacement Budgets				39.3
Government Contribution As Employer to Income Replacement Budget				26.6
TOTAL OUTLAYS	1515.4	180.2	425.4	1047.9
DEFICIT	-264.1	-152 6	85.3	-196.8

Note. Detail may not add due to rounding
* Not included in the totals in the unified budget structure.

BUDGETARY DISCIPLINE AND DEFICIT CONTROL

The budget restructuring I have discussed today will help policy makers understand the scope and nature of spending, will lead to improved decision making, and will increase budgetary discipline and the ability of Congress to monitor and control the Federal deficit.

For more than two decades, the Federal budget deficit has been an intractable problem, and there is now a long history of masking the magnitude of the problem with budgetary "blue smoke and mirrors." Separating current consumption into the operating budget will focus the attention of policy makers on the imbalance between revenues and expenditures. The masking of deficit spending and certain types of obligations will end. Establishing an income replacement budget will enable Congress to understand the government's commitment to workers and to evaluate the appropriate revenue sources for these programs. The level of general subsidy for these programs will also be clear.

The importance of a capital budget is the ability to focus Federal spending in ways that increase economic growth, which will help reduce the deficit over the long term. A difficult issue that will have to be addressed in a capital budget is the treatment of depreciation.

In the private sector, investment typically is not charged as a current expense. The treatment of depreciation in the capital budget will differ from private sector practice in a fundamental way. The private sector typically integrates accrual accounting, including depreciation, into its financial management system. In contrast, the U.S. government's financial management system is on a cash basis. The reason for this is that the Congressional appropriations process exerts its control over

executive branch spending at the point of obligation of funds. An executive branch official who obligates funds for which there is not a congressional appropriation violates the Anti-Deficiency Act of 1905, which codifies the long-standing Anglo-American tradition of legislative control over appropriations, and which prescribes criminal penalties for violation.

The total integration of accrual accounting, including depreciation, into executive branch financial management could weaken the control through the obligations process, and would precipitate strenuous opposition. If a capital budget were to be implemented as a way to reduce the deficit on paper, the concept could be seen as just another budget game. I do believe that accrual accounting schedules should be developed and utilized by authorizing committees in developing policies that include long-range commitments. They should not be used, however, in the budget or appropriations bills; we should not jettison the budgetary discipline that cash-based obligations impose on Federal officials. Appropriations should continue to be on a cash basis; and accrual measurements, including depreciation, should not be the basis for appropriations actions or financial management.

A depreciation schedule should be developed in order to calculate net capital investments. This will require the valuation of Federal assets and the development of agreed-upon depreciation rates. It is crucial to the development of capital budgeting that this effort not become tied up with budgetary politics about the deficit. The importance of a capital budget to deficit reduction is not an immediate reduction in the deficit due to depreciating instead of expensing investment, which I do not recommended at this time. It is also important that capital budgeting not be deferred until the depreciation estimates can be refined and validated.

An additional reason for proceeding with caution in the integration of accrual accounting, including depreciation into the budget process is the fact that no State budget currently includes imputed depreciation.[17] Until validated public sector depreciation estimation techniques can be developed, the Federal government should emulate state practice in implementing capital budgeting and not include depreciation estimates. Methods of calculating depreciation should be studied, and maintenance, repair and replacement should be factored into decision making, if not into the budget itself.

A capital budget will help policy makers weigh the long-term costs and benefits of spending decisions. While the president's budget often contains excellent budget arrays which separate investment and R&D funding from other types of spending, neither in the budgets themselves nor in the congressional review of the budgets are there separate systematic reviews of spending requests which have the potential to increase productive capacity. Instead, both OMB and the appropriations subcommittees conduct budget reviews by department and agency that do not distinguish between consumption-oriented and investment-oriented spending.

The alternative budget structure that I have proposed, including various tax expenditures or subsidies, will isolate out the government's investment and its income replacement activities, providing a better display of the range of Federal liabilities and obligations. This budget presentation also will give us the opportunity to earmark trust fund surpluses for investment activities, thus allowing us to move away from eating

---

[17] Henry Thomassen, "Capital Budgeting For A State," Public Budgeting and Finance, Vol. 10, Number 4 (Winter 1990), p. 85.

our seed corn by using Social Security trust fund surpluses to finance deficit spending in the operating activities of the government.

Tax expenditures could also be included in the restructure, and to do so would be fairly straight forward. OMB and the Department of the Treasury now develop tax expenditure estimates that include outlay-equivalents and revenue loss. In fact, we have used these excellent estimates in an analysis that we have in process for the National Committee to Preserve Social Security and Medicare. This analysis shows that the outlay equivalent of tax expenditures for individuals is dominated by housing and health-related items. These two activities account for 42 percent of tax expenditures for individuals. In contrast, tax expenditures related to current retirees is only 7.5 percent of the total individual tax expenditures and deferral of taxes until retirement accounts for 22.4 percent of current tax expenditures for individuals.

Including tax expenditures would greatly increase the perceived size of the Federal budget, and could significantly alter our perspective on how government spending is allocated.

If tax expenditures are included directly in the restructured Federal budget, they should be placed in the budget based on their purpose. For instance, tax expenditures related to R&D, educational expenses, state and local infrastructure, and housing could be considered investment and would be included in the capital budget. Tax expenditures related to exclusion from income of pension plan contributions and of social security retirement benefits would be included in the income replacement budget. Other tax expenditures, such as those related to health care would be included in the operating budget.

Mr. Chairman, proponents of retaining the unified budget often cite the need to keep as the bottom line of the budget, the amount that the government will have to borrow from the public, which is the deficit figure in the unified budget. This is a number that decision makers and the markets need to know, and any budget restructuring should continue to make this calculation. However, the narrow focus on the unified deficit over the last 25 years has not served to keep that deficit under control, but it has served to mask the true size of federal spending and deficits. It also has obscured from policy makers the scope of government interaction in the economy. The total level of government obligations for Fiscal Year 1994 is not $1.5 trillion, the bottom line outlay figure in the unified budget and the figure that the press and most people cite as the total level of government spending. That is a net figure. When you add in interest owed to trust funds, the government's obligations as an employer, and outlays that have been netted out by fees and other collections, the total level of obligations, as pointed out earlier is $2.1 trillion. If you add to that the outlay equivalent of tax expenditures, which is almost half a trillion dollars, the total level of government activity is $2.6 trillion, more than a trillion dollars more than the net outlay figure currently shown in the federal budget. It is clearly time to change the budget structure to give policy makers the information needed to improve our nation's fiscal policies.

CONCLUSION

The fiscal policies of the last decade have left a legacy of debt and deficits which have impeded economic growth, and the situation is in fact worse than is generally known. The decision on whether to change the structure of the budget should ultimately be based on whether it will enable better decision-making. That

consideration is what motivated thinking on the budget restructuring proposal presented today.

The challenge is to lay bare the true nature and extent of the deficit, end the budgetary gimmickry that has helped create the current crisis, and set spending and revenue policies on a path that will lead to an end to the unwise and foolish practice of borrowing to finance current consumption. At the same time, it is imperative that the nation invest in its future, in the human and physical capital that will stimulate productivity and economic growth. The budget must become a tool that leads to sound decision making on federal fiscal policy.

Appendix
Detail on Budget Restructuring

The following tables summarize:

(1) Appendix Table 1 sets forth total government positive outlays proposed for fiscal year 1994, and excludes netting of negative outlays and includes transfers to trust funds.

(2) Appendix Table 2 sets forth investment outlays in Fiscal Year 1994, excluding investment in education and training. The program levels are those proposed in the Clinton Fiscal Year 1994 Budget released in April 1993.

(3) Appendix Table 3 sets forth the outlays for the education and training programs proposed for inclusion in the Capital Budget. Grants for elementary, secondary and vocational education, grants and loans for post secondary education and the National Service Trust fund would be included in the Capital Budget, as would training and employment assistance programs.

(4) Appendix Table 4 sets forth the outlays for selected programs which are possible candidates for inclusion in the capital budget.

(5) Appendix Table 5 sets forth the programs proposed to be included in the Income Replacement Budget.

(6) Appendix Table 6 sets forth the outlays in Operating Budget by Budget Function.

Appendix Table 1
Federal Obligations
Before and After Offsetting Collections and General Fund Subsidies
Fiscal Year 1994 (April 1993)
(in billions of dollars)

	Gross Obligations	Payments by the Public That Finance Increased Spending	Payments by the Public That Mask Spending	Transfers from the General Fund That Finance Increased Spending	Other Transfers	Net Obligations
Total for Government	2,146.9	(166.2)	(48.4)	(172.8)	(238.2)	1,521.3
Executive Branch						
Department of Health and Human Services (Except Social Security)	401.1	(4.6)	(18.3)	(4.0)	(46.6)	327.6
Department of Defense (Military)	364.9	(8.9)	(0.8)	(94.2)	(0.2)	260.8
Department of the Treasury	351.9	(2.5)	(3.2)	(12.8)	(14.5)	318.9
Social Security	324.1			(1.8)	(6.5)	315.7
Department of Agriculture	87.0	(19.4)	(1.8)	(3.9)		61.9
Office of Personnel Management	79.2	(8.1)	0.0	(14.2)	(19.9)	38.9
Other Independent Agencies	58.1	(39.3)	(0.1)	(0.9)	(0.8)	17.1
Postal Service	53.5	(48.2)	0.0	(1.7)		3.6
Department of Labor	49.3	(1.5)	(0.2)	(5.7)	(3.3)	38.6
Department of Defense (Civil)	47.4		(0.3)	(3.3)	(13.0)	30.8
Department of Transportation	46.1	(0.2)	(0.1)	(4.7)	(0.2)	41.0
Department of Veterans Affairs	43.7	(2.0)	(1.3)	(3.6)		36.8
Department of Housing and Urban Development	38.2	(7.4)	(0.4)	(1.4)		28.9
Department of Education	32.3	(1.8)	(0.1)			30.4
Department of Energy	28.4	(4.2)	(1.9)	(3.1)	(0.6)	18.6
Funds Appropriated to the President	26.8	(0.5)	(14.1)	(0.5)		11.8
Federal Deposit Insurance Corporation	18.6	(15.7)	0.0	(0.1)		2.8
Other Executive Branch	88.6	(3.7)	(6.1)	(15.7)	(7.9)	55.2
Total: Executive Branch	2,139.2	(166.1)	(48.4)	(171.7)	(113.5)	1,639.5
Legislative Branch	4.3	(0.1)		(1.0)		3.1
The Judiciary	3.5		0.0	(0.1)	(0.1)	3.2
Undistributed Offsetting Collections	0.0	0.0	0.0	0.0	0.0	0.0
Interest received by trust funds	0.0	0.0	0.0	0.0	(86.1)	(86.1)
Proprietary Receipts	0.0	0.0	(3.6)	0.0	(3.6)	(3.6)
Employer Share, employee retirement	0.0	0.0	0.0	0.0	(34.8)	(34.8)
Total, Undistributed Offsetting Collections	0.0	0.0	(3.6)	0.0	(124.5)	(124.5)

Appendix Table 2 Summary of Capital Budget Outlays Excluding Education and Training Fiscal Year 1994 (In billions of dollars)	
	1994
National Defense direct investment	8.5
Non-Defense investment	61.6
Research and Development	70.4
Total; Capital Budget Outlays (Excl. Education and Training)	140.5

Appendix Table 3 COMPOSITION OF OUTLAYS FOR THE CONDUCT OF EDUCATION AND TRAINING 1992 - 1994 (in billions of dollars)			
	1992	1993 est.	1994 est.
Elemantary, secondary, and vocational education	12.3	14.6	15.2
Higher education	11.3	13.6	13.0
Research and general education aids	1.8	1.9	2.0
Training and employment assistance	4.9	6.0	5.7
Total; Education and training	30.3	36.2	36.0
Income Security	0.1	0.1	0.1
Veterans education, training and rehabilitation	1.0	1.0	1.4
Health	0.7	0.8	0.8
International Affairs	0.2	0.2	0.2
Other education and training	0 8	1.0	1.0
Total. Conduct of education and Training	33.1	39 4	39.7

Appendix Table 4 – POSSIBLE CANDIDATES FOR INCLUSION IN THE CAPITAL INVESTMENT BUDGET
Fiscal Years 1991 actual and 1994 President's Request (April 1993 Request)
(in billions of dollars)

	1991 actual	1994 Request
Child Nutrition	5.54	7.49
Women, Infants and Children Nutrition Assistance (WIC)	2.28	3.27
Maternal and Child Health Block Grant	0.59	0.66
Childhood Immunization	0.22	0.34
Social Servicee Block Grant (Title XX)	2.83	2.80
Total	11.45	14.56

Appendix Table 5 Income Replacement Budget Fiscal Year 1994 Current Services (April 1993) (in billions of dollars)	
	1994
Human Resources	
Social Security	318.1
Income Security	
General Retirement and Disability	
Railroad Retirement	4.2
Other	0.9
Subtotal: General Retirement and Disability	5.1
Federal Employee Retirement and Disability	
Civilian Employee Retirement	36.4
Military Retirement	26.8
Subtotal: Federal Employee Retirement and Disability	63.2
Unemployment Compensation	24.4
Subtotal: Income Security	92.7
Veterans Benefits and Services	
Compensation	14.6
Subtotal: Veterans Benefits and Services	14.6
Total: Outlays For Income Replacement Programs	425.4

Appendix Table 6 Major Elements of the Operating Budget Fiscal Year 1994 Estimates (In billions of dollars)	
Interest on Public Debt	309.6
Defense and International	219.0
Science and Energy	4.7
Natural Resources	11.9
Agriculture	16.1
Commerce and Housing	8.5
Transportation	13.2
Community and Regional Development	2.5
Education, Training, Employment and Social Services	13.9
Health	107.5
Medicare	147.4
Income Security	122.3
Veterans	21.9
Administration of Justice	0.2
General Government	14.2
General Fund Contribution to Income Replacement Budget	26.6
Other	8.3
Total Operating Budget	1047.9

Mr. CONYERS [presiding]. Maybe it is because we do not want to know. I hate to suggest that, since you were a Senate staffer and Jim was a House person. I mean, it may not be an accident.

What advice would you give the administration on this subject in terms of capital budgets and the related matters that bring us here this morning?

Ms. CHAMBERS. We know the President went on record during the campaign as favoring separation of an investment budget. He also talked about a tripartite budget which would be much as the budget that Dr. Rotherham and I have set forth, which has a separate part for past commitments made to workers.

So we know the President has favored separating investment spending from the rest of the budget. In the National Performance Review, the Vice President has gone on record in favor of a capital budget. It is not fully developed, I think, at this point; but it is more related to physical facilities.

My guess is that over at OMB, an institution that is traditionally opposed to moving away from the unified budget, there may be some difference of opinion with the President and Vice President.

My advice to this administration would be that if this administration's priority is to increase investment in the future, which is a major priority that the President has expressed investment must be separated into a separate budget presentation, and it must be a part of the decisionmaking document that the budget committees and the Congress use to determine expenditure levels. Restructuring the budget is imperative if we are going to increase investment spending.

Mr. CONYERS. Jim, welcome back to these hallowed halls. Do you have anything you would like to add?

Mr. ROTHERHAM. Thank you, Mr. Chairman. The one thing I would add is that, as this committee well knows, changing the Federal budget is like changing course with a huge ship. However, we should not necessarily look for protection to wait until we get the perfect set of numbers before we institute change, because if you do that, there will never be any change.

Mr. CONYERS. OK. Thank you.

Do you have a concluding sentence? I want to get to Mr. Posner before the bells ring.

Ms. CHAMBERS. I think, very quickly, there are other things that one can look at. Tax expenditures, for instance, are another $500 million of Federal activity if you take the $2.1 trillion of actual outlays and add that $500 billion, it totals in government activity, $2.6 billion. I don't want to get bogged down in numbers, but this shows the magnitudes of the portions of the budget not scrutinized carefully.

I think the efforts to very carefully factor in what we are doing in areas that are not in the budget now, like tax expenditures, like negative outlays, and like the subsidies that we make for the use of government properties, et cetera, the grazing fee issue, that sort of thing, I think those are all very important.

I would also recommend that we make some movement toward looking at a government balance sheet, at accrual accounting, depreciation estimates. But I would recommend those not be incor-

porated into the budget document itself but that the budget be a cash document.

So I think the final issue is that we should make changes on a cash basis by restructuring the budget itself. We should also develop additional tools for decisionmaking with regard to financing of government programs.

Mr. CONYERS. I look forward to developing this with you in the coming term, because I think we are finely peeling past the rhetoric and getting into more careful deliberations of these large fiscal and accounting concepts. I thank you very much.

I would now like to turn to Paul Posner, Director of Budget Issues at the General Accounting Office. Mr. Posner, you have the last word here.

Has anything gone on this morning in government operations that you leaves you highly disturbed?

STATEMENT OF PAUL L. POSNER, DIRECTOR, BUDGET STUDIES, GENERAL ACCOUNTING OFFICE

Mr. POSNER. I find myself in agreement with much of what has been said.

I think, in answer to your question to Letitia, that, in fact, we would probably suggest to OMB that they develop an investment component in the budget, to be established with an unified budget itself, component should be used to encourage decisionmakers, both in the Congress and in the executive branch, to prompt them to decide what portion of the budget they want to devote to long-term investment—a decision they do not make now, a decision that arises from thousands of individual decisions made all over this place. It would be very useful to focus on that, No. 1, just to get people focusing on what the Federal role is.

As you know, in some sense, there are two Federal roles in promoting long-term economic growth, which is something we are all concerned about. We are all concerned about the declining levels of savings, the declining levels of investment compared to our trading partners. One is the effects of the deficit itself on a unified budget basis. It is far too high, far too chronic, and has an effect on long term on savings.

That is one thing established. We have a budget that focuses on that. We have macro economic policy goals. What we do not have in the budget is a focus on the other part of the budget that affects the long-term economy which is this portion of the programs that affects growth, whether it is infrastructure, whether it is R&D, whether it is human capital.

Financing deficit reduction by cutting effective investment programs can impact long-term growth and is probably not the way you want to grow. We do not have a budget process that forces you to focus on these tradeoffs. That is part of the problem, I think.

I wanted to hold up two reports we have done for you. The one we are issuing today is on, how do you incorporate an investment component in the budget? What is the thinking on that? The other one we issued to you and Senator Bradley a couple of months ago provided a framework of questions you might ask about investment proposals.

In other words, once we have this investment component in the budget, how do you go about thinking about what is the most effective kind of program to fund?

Mr. CONYERS. We are delighted to receive them both.

[To reduce publication costs, the subcommittee has omitted from the record a November 1993 GAO report entitled, "Budget Issues, Incorporating an Investment Component in the Federal Budget," GAO/AIMD–94–40, and a July 1993 GAO report entitled, "Federal Budget, Choosing Public Investment Programs," GAO/AIMD–93–25. A copy of the reports may be found in the subcommittee files.]

Mr. POSNER. Thank you.

The problem of to establish an investment component, raises a point that one of our panelists raised on a consulting panel we convened on the subject. Investment is a wonderful analytical concept fraught with the potential for budget mischief. So as important as it is to promote these kinds of efforts, the question is: How do you structure it in a way that prevents us from doing violence to other values that we hold dear in the budget process?

Mr. CONYERS. What is the game playing potential of that?

Mr. POSNER. One is simply the definitional component. If you make this part of the budget more attractive, either by permitting deficit financing or by defining these programs, booking the costs on a depreciated basis so you do not pay for them all at once, you pay for them over 30 years, the temptation in a constrained environment is everything will tilt toward this part of the budget. That is the natural human behavior particularly when spending has been so constrained over the years. It would be natural for advocates to try to paint any program they could as investment.

A case could be made for a broad range of things. That is the rub. The question is how direct or indirect is their link to promoting long-term economic growth?

You know, certainly when you talk about highways, talk about airports, talk about those kinds of programs, job training partnership, there is a fairly direct link. Now there are real questions raised about how much of that money actually gets down there and does good, because the buckets are awfully leaky. But nevertheless, that is—those are programs that have a direct link.

When you get to things like social services or health care, I think the economists view those as more a consumption basket. On the other hand, advocates try to suggest if we spend money on drug control, on mental health, we are creating more productive citizens down the road, potentially. There is this shred of a link. It gets increasingly tenuous as you go down the chain.

But nevertheless, an argument is still mounted on these grounds. So that is one of the things that concerns you about this.

What we tried to do here is first of all look at that definitional question. In our report, we developed what we call a fairly restrictive option that includes programs that are directly intended to effect investment. And roughly about $130 billion of outlays in fiscal 1992 go into that basket.

It is important to note that once you get this definition, that is only the first hurdle. You also have options in terms of how you treat it in the budget. What we talk about in the report, are four

ways that the investment component or the investment definition could be employed in a budget process.

One is, what we do now, which is display. OMB has been displaying funding for investment and infrastructure for some years now. The problem with a display is it is after the fact. It doesn't guide decisions. It simply records the impact of decisions. It is useful but simply does not go the way we think we need to go.

A second approach that we have discussed is the depreciation concept, which has been considered by some people as a way to overcome what is called the bias against capital in the budget. So instead of having to fund everything up front, if you are paying for a dam for example, you would be able to fund it over 30, 40 years, the useful life of the project. That way it is on a more comparable basis with the benefits that it gives you over that time.

There are numerous problems at this point in time with applying depreciation. Most of what we finance in the way of the investment, we do not own. We primarily subsidize other actors in the economy, principally State and local governments and businesses, to promote highways, research and development, education, and training.

So from an accounting balance sheet perspective, that perspective falls short of really capturing the essence of what we do in the investment area. One reason why depreciation doesn't work is that traditionally you only depreciate that which you own. We end up depreciating just a very narrow range of assets.

Second, we really do not know how to depreciate at the Federal level. The accountants haven't figured it out yet. I am on a task force of the Federal Accounting Standards Board which is trying to figure this question out. I think the accountants have considerable questions about how you would, in fact, depreciate these assets. A historical basis? A replacement cost basis? How do you deal with monuments and things we wouldn't call investments but are fixed assets that we would never replace?

The third thing that bothers me about the depreciation notion, even if we could get the accounting break, is the principle of budget control—you should pay for the full costs of what you are doing when you make the commitment up front. This principle could be violated by a depreciation scheme if funded in the budget.

The danger is that we might back our way in one-thirtieth of a time each year to fairly expensive investments. It is probably wise from a benefit-cost standpoint to recognize and fund the full costs of programs up front.

We have also looked at arguments made for deficit financing of this section of the budget. We are frankly not convinced that this is an appropriate approach at this time when the deficit is so large as a share of our budget and GDP.

Some argue that, like States, we should deficit finance, that government investment, as we heard this morning, does increase—investment possibly more than the private savings in investment it displaces.

As I say, first of all, the deficit is so high, you would like to have that argument made once we brought it down to a reasonable bound. Then we could have a reasonable argument about that.

The second is the potential to crowd out the private investment, particularly as the economy heats up to full capacity; and you have to make the assumption that your public investments are, in fact, having a higher rate of return than the private investments you would be displacing. When you look at the record of public investments, you cannot be comfortable with that record.

The third has to do with budget controls. Once you establish by deficit financing, you establish a tremendous incentive to define everything as investment, and it really raises the specter of increasing spending beyond reasonable bounds. However legitimate a concept it may be in economic terms, when you set it in motion against the real life world of policymaking here, I think it worries those of us in the budget community about the potential for things getting out of control.

Finally, along those lines, unlike States and businesses, the Federal Government does not have a market to regulate our appetite for capital. States do with the bond market. Businesses do as well.

We think the most promising approach for starting on this journey to promote better cognizance of the investment consequences of our decisions is to establish, as I said, these targets within the unified budget. We think it has the prospect of changing the terms of debate, of focusing decisionmakers on what they are doing, on which programs, in fact, have the greatest investment potential without changing the way we book costs, without getting into the murky world of deficit financing which we think has real downsides.

Well I also think it will prompt us to ask the kind of tough questions that we need to ask which we tried to discuss in this July report and the framework. Those questions are fairly daunting for public investment.

When you think of any Federal program, you would like it to be effective, you would like it to be cost effective. When you think if a Federal investment program, it has more rigorous standards to meet because it has to have an impact on the private, long-term rate of return, the private productivity long term.

That is a pretty rigorous test. I will give you an example. The Job Training Partnership Act has had, perhaps, more experience than most programs in program evaluation. They have found, after some early going, that they managed to establish a fairly good placement rate for their trainees. Well, that is one measure of a program's success that has been trumpeted.

The problem is later control studies have found that those trainees that got jobs, stood to get jobs just as well without the program. In fact, one group of participants stood a worse chance of getting a job by being in the program than if they were not in the program. This was a recent control study done by Abt Associates, fairly surprising result which suggests the program may not be having the impact on productivity in the long term that we thought it had.

The second test that you want a program to satisfy in this regard is that it—the participants, in fact, not simply be displacing other job applicants who might have gotten that job that they got. That is the way you promote some net increase in output.

So those are some of the difficult questions we have to ask. The investment component might force you to focus on is to better look

at how we are designing these programs; how we are preventing these programs from essentially being leaky buckets. When you look at studies of our highway programs, for example, you find that about 60 percent of the Federal grant funds, in fact, simply supplant State and local spending that otherwise would occur in those programs. We looked at the R&D tax credit as GAO did, the targeted jobs tax credit. We find at least a portion of those benefits are fiscally supplanting spending anyway or not really changing behavior in any way.

In some sense, that is the real ultimate definition of waste in government spending. If you are spending big dollars and not promoting any change in this spending behavior or program behavior, that is a definition of waste.

Somehow we have to have a process that forces us to look more closely at the results of these programs. So that is fundamentally the other fairly challenging agenda that those of us interested in this concept face.

[The prepared statement of Mr. Posner follows:]

United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Legislation and National Security
Committee on Government Operations
House of Representatives

For Release on Delivery
Expected at
10:00 a.m.
Tuesday,
November 9, 1993

BUDGET POLICY

Investment Budgeting for the Federal Government

Statement of Paul L. Posner
Director, Budget Issues
Accounting and Information Management Division

GAO/T-AIMD-94-54

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss federal capital budgeting. In addition to testifying before the Subcommittee this morning, we are providing our report on incorporating an investment component in the federal budget. The report discusses in greater detail many of the issues that I am about to present to the Subcommittee.

Capital budgeting proposals for the federal government are usually advanced as a way to differentiate between spending for the long-term and spending for current operations. Analogies are made both to the private sector and to state budgets. In looking at proposals for a federal capital budget, however, it is important not only to examine these analogies but also to recognize several different aspects of this spending for the long-term versus the short-term as it relates to the federal budget.

The federal budget can be seen both as the budget of an operating entity--the federal government--and as the document through which the federal government expresses its role as the government of a nation. These two roles present different issues.

As an operating entity, the government must be able to make expenditures that increase internal efficiency and maximize the use of scarce resources. For example, the government must make decisions concerning whether to lease or purchase an office building, or whether the increased efficiency provided by the

purchase of a computer system will result in benefits greater than cost. Current budget rules are thought to skew these choices. Important as this issue is, however, there is another focus of concern about capital or investment budgeting.

Much debate--and my discussion today--deals with the role of government investment in the long-term productive capacity of the economy. The spending and revenue policies of the federal government affect both the short-term and the long-term economic health of the nation. We believe that increasing attention must be paid to how the federal budget affects the latter; the budget should help policymakers focus on the longer-term impact of budget decisions. In particular, we need to improve our ability to distinguish between those federal programs that increase long-term economic growth and those that primarily support current consumption.

The nation's long-term economic future depends in large part upon today's budget and investment decisions. However, trends in economic investment are not promising--private economic investment's share of GDP stands at its lowest levels in three decades. Moreover, our major trading partners have significantly higher levels of investment. Failure to reverse these trends will doom future generations to a relative decline in their standard of living.

Because the deficit absorbs private savings otherwise available for domestic investment, it exerts the single most important federal influence on investment. The surest way to increase national savings and investment would be to reduce this unprecedented level of federal dissaving by reducing the deficit. In a report issued in June 1992, we stated that moving from a deficit to a budget surplus is essential to improving national savings, private investment, and long-term economic growth. We said that these are vital actions to help the next generation of workers support a larger number of retirees.[1] Moreover, we concluded that we have no choice but to deal with the deficits now because failure to take action could result in deficits rising to 20 percent of gross national product (GNP) by the year 2020, due primarily to rising health, retirement, and the associated interest costs.

In addition to deficit reduction, well-chosen federal investment programs can also promote an environment conducive to investment and long-term growth in ways that the market alone cannot provide. Programs supporting efficient public infrastructure such as transportation systems, an educated work force, and expanded technological innovation can make important contributions. Indeed, it would be unfortunate if, in the process of cutting the deficit to increase private investment, the government reduced effective federal investment programs as well. Recent budget trends have not

[1]Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy (GAO/OCG-92-2, June 5, 1992).

been encouraging for either the deficit or federal investment programs.

COMPOSITION OF THE BUDGET

The growing portion of the budget absorbed by interest payments and consumption programs, particularly health, has squeezed the discretionary sector of the budget, which is the source of most federal investment funds. Federal outlays for investment programs (physical capital, research and development, and education) declined as a share of GNP between 1980 and 1984 and have remained relatively stable at the lower level since then. During the 1980s, both federal health spending and net interest payments on the national debt surpassed the federal share of GNP for public investment.

These trends in the investment share of the budget did not result from an explicit strategy or set of national priorities. Instead, they represent the accumulated results of many individual budget decisions regarding dozens of programs. The current budget structure does not adequately meet the needs of decisionmakers and an informed public since it makes no distinction between current consumption and investment decisions that promote longer term economic benefits.

Currently, the federal unified budget focuses policymakers' attention on the impact of federal cash borrowing on the economy. Such a focus is critical to understanding how federal budgetary decisions in the aggregate affect the business cycle in the short term as well as potential consequences for longer term economic output. However, the unified budget does not highlight the different impact that various types of spending would have on the long-term potential output of the economy. Federal spending for well chosen investment programs most likely increases the future capacity of the economy, compared to an equivalent amount of spending for consumption programs.

By recognizing the different impact of various types of federal spending, an investment focus within the budget would direct attention to the consequences of choices within the budget for long-term economic growth. Policymakers would then have a new tool for deciding investment and consumption priorities within the budget as well as prioritizing programs within the investment sector.

WHAT IS AN INVESTMENT COMPONENT?

Having established the need for such an investment focus is only the first step down a long path toward defining and implementing such a concept in budgetary terms. There is no single "right" way to define capital for budgeting purposes. The point is that the

budget should highlight for policymakers the group of programs that they consider to have long-term benefits warranting their attention.

Although definitions of what constitutes a capital investment may differ, traditional capital budgets normally define capital assets narrowly as tangible assets of a specific dollar value that are intended for long-term use or possession, are relatively permanent in nature, and are not intended for resale.

Business enterprises have capital budgets that show large physical capital outlays scheduled to be made in future years, the proposed means to finance them, and their expected benefits. The purpose of these budgets is to help evaluate the need for and costs of acquiring and financing long-lived assets. For financial reporting purposes, businesses charge depreciation in order to (1) allocate proportionately the investment costs of depreciable assets to each accounting period during which the asset is used in the production of goods and services and (2) recognize the decline of service potential.

In our 1986 report on states' capital budgeting practices,[2] 37 of 45 states responding to a questionnaire indicated that they had a distinct capital budget which reported capital amounts separately.

---

[2]Budget Issues: Capital Budgeting Practices in the States (GAO/AFMD-86-63FS, July 15, 1986).

Frequently, the states' capital items are separated from the operating budget because most states have a legal requirement to balance operating budgets. State governments often issue long-term debt for capital investments in the form of earmarked bonds and generally do not include depreciation of capital assets in their budgets.

For the federal level, the investment budget focus we have in mind includes spending on activities that enhance long-term productivity, regardless of whether they are tangible or intangible, and focuses on investments for the benefit of the economy as a whole, not just the federal government. Like the states, such a budget would include some federal investments in physical capital. But the scope of a federal investment budget should be broader to encompass the types of programs we undertake that are intended to have an impact on long-term economic growth--principally spending on research and development (R&D) and education and training as well as some physical capital. Since states often cannot capture the benefits from R&D or job training, the federal government has assumed a major leadership role in these areas.

Under this concept, a federal investment budget would include grants for physical capital and spending for R&D and human capital activities, such as education and training, which are directly intended to increase private sector productivity. It would also

80-712 - 94 - 7

include spending for some federally owned physical capital, such as construction of research and development facilities, water projects, and air traffic control systems having a direct bearing on long-term economic growth. Unlike traditional capital budgets, however, an investment budget would not include spending on physical assets, such as federal office buildings and military weapon systems, which are primarily used to carry out federal agency missions. Such expenditures may improve the efficiency of government operations and create jobs in the short term in particular regions of the country; however, they do not directly increase the private sector's longer term productive capacity.

Budgeteers have expressed a concern about investment or capital budgeting potentially elevating the programs covered to the status of sacred cows, thus providing an incentive to distort the definition of investment to include programs which have only tangential long-term economic benefits. This is a legitimate concern that surrounds any effort to make meaningful distinctions in the budget. However, controversial definitional issues can be resolved, as the 1990 Budget Enforcement Act proved in defining mandatory programs. To develop and enforce a definition of investment, the executive and legislative branches would need to reach a similar agreement. Furthermore, we believe that vigilant oversight is vital to avoid abuses; periodic reviews of the implementation of investment budgeting would help to do so. Controversy over the definition will likely escalate if the

investment category receives any type of favorable budget treatment.

USING AN INVESTMENT COMPONENT IN BUDGETING

Definitional issues are only one of a series of decisions that need to be considered in developing an investment, budget. Other issues include determining how to use such budgetary information in (1) making resource allocation decisions about the overall size of federal borrowing and the deficit and (2) allocating federal resources among competing budgetary claims.

I would like to discuss four alternative approaches for using an investment component to make budget decisions and helping the government focus on long-term economic growth:

-- display federal spending as investment or noninvestment;

-- include depreciation of investment activities in the budget;

-- permit deficit financing of investment activities; and

-- establish annual investment targets agreed upon by the Congress and the administration.

The approaches are not mutually exclusive. They are presented separately in order to discuss their potential effectiveness as vehicles to focus on the investment consequences of budgetary decisions. Among the issues to be considered are the potential problems each approach could cause for budgetary control and the conduct of overall fiscal policy.

Display Investment Activities

In this approach, the President's budget presentation would categorize and display spending and revenue as investment or non-investment based on established criteria applied to the activity's intent. The Office of Management and Budget currently classifies all spending in federal budget accounts as investment or noninvestment using character classification codes after executive budget decisions have been made. This coding structure, if used in executive branch budget formulation, could be used as a starting point to identify investment activities in the budget based on any agreed-upon definition of investment.

For many years, an alternative budget presentation, or special analysis, that distinguished between spending for investment and spending for current operations accompanied the President's budget. Special Analysis D, "Investment, Operating, and Other Outlays,"[3]

[3]The title of Special Analysis D changed over the years. It has also been called "Federal Investment and Operating Outlays" and "Federal Investment Outlays."

was included in the special analyses budget document from the 1950s through the 1990 budget presentation. Beginning with the 1991 budget, alternative budget presentations on physical and other capital replaced Special Analysis D. A collection of summary tables, "Federal Investment Outlays," is included in the fiscal year 1994 budget.[4] These presentations included as investment major defense and nondefense spending for physical capital, research and development, and conduct of education and training. The displays distinguish between national defense and nondefense investment outlays and between grants to state and local governments and direct federal investment outlays.

However, these presentations are used only to provide supplemental data. None of these alternative presentations has been used in budget formulation, and none has been part of the formal budget process. The presentation is assembled after executive budget formulation decisions have been made. Further, the current presentations do not include the entire budget so that spending for investment can be compared with spending for consumption. Nevertheless, such a display could prove to be useful in providing additional information for the congressional decisionmaker. In addition to displaying investment outlays as they relate to total federal spending, other additions to the investment information

[4]This presentation is different than the budget section "Investment Proposals," which is a list of appropriation accounts by agency for which the administration is seeking increased levels of funds.

presented in the budget could be useful in evaluating total public investment. For example, the display could include information on investment effectiveness; tax expenditures related to investment; deferred maintenance; and historical information about federal, state, and local spending on investment.

Depreciate Investments

This approach would report the total up-front cost of investments in a capital portion of the budget and the annual depreciation in an operating portion of the budget. Thus, this would spread the investment costs over the life of the investment, and the operating budget would reflect the cost of goods or services in the period that they are used or consumed.

Depreciation has been a long accepted part of accounting in business organizations. Under business accounting practices, depreciation is the allocation of the costs, less salvage value, of fixed assets, including equipment, buildings, and other structures, over their useful lives. It is recorded in a business organization's financial statements to reflect the use of assets during specific operating periods in order to match costs with related revenues in measuring income and to determine the organization's profit or loss, its federal tax liability, and the depreciated value of the asset.

State governments neither budget for depreciation nor charge their operating budgets with depreciation. They often use separate capital and operating budgets because they are legally required to balance their operating budgets. Most charge the operating budget with debt service--principal and interest--when bonds are sold to finance the capital.

Depreciation is not currently used in the federal budget, but capital budget advocates argue for its use. Appropriations and outlays are normally recorded on a cash basis in the budget; thus, the costs of programs intended to produce future benefits are recorded up front. Capital budget advocates argue that this large up-front commitment of resources, and the resulting additions to total spending, make investments unattractive spending decisions compared to other types of spending, especially under the current budget process with its spending caps.[5]

Depreciation is not a practical alternative for the Congress and the administration to use in making decisions on the appropriate level of spending intended to enhance the nation's long-term economic growth for several reasons. Currently, the law requires agencies to have budget authority before they can obligate or spend funds on any item. Unless the full amount of budget authority is required to be appropriated up front, the ability to control

[5]Given the Budget Enforcement Act discretionary budget caps, if resources are committed up front for capital items, spending for alternative discretionary items is squeezed out.

decisions when total resources are being committed is reduced. Appropriating only depreciation, which reflects only a fraction of the total cost of an investment, raises this control issue.

In addition to the fund control issue is the difficulty of determining an appropriate depreciation amount. Investments in human capital would be particularly difficult to depreciate because of the difficulties in measuring the future value and useful life of human capital. Also, depreciation schedules are often somewhat arbitrary; thus, including depreciation in the budget could result in spending decisions being based on questionable data. Questions have also arisen over the issue of the federal government allocating depreciation for physical assets such as highways that are financed with federal funds but are owned by state and local governments.

Depreciation could be useful if the purpose of creating an investment budget component is to make decisions about spending which has future benefits to the government as an operating entity. For example, greater use of revolving fund concepts--including depreciation as part of a user charge--to finance internal agency capital purchases could promote greater agency attention to their costs and benefits.

The Federal Accounting Standards Advisory Board (FASAB) is addressing the appropriate use of depreciation for federal

accounting purposes. It is not clear what types of spending, if any, would be depreciated for accounting purposes. If depreciation concepts are to be used in budgeting, it would be desirable that they be developed in concert with accounting concepts.

Deficit Finance Investments

This approach would permit borrowing to finance investment. In a traditional capital budget, capital is often financed through long-term borrowing. The majority of state governments have some form of a capital budget. States use a combination of short-term and long-term debt to finance capital expenditures. Long-term debt, however, is the most frequently used debt financing tool for capital assets. Some advocates of intergenerational equity (which calls for spreading the costs fairly among the generations receiving benefits) argue that capital items, which are used for many years, should be financed by borrowing. In theory, the term of the borrowing should coincide with the life of the capital asset and, as a project generates services over a number of years, the services would be paid for by the generation benefitting from them. In practice, however, states finance capital projects through a combination of current revenues and debt financing, but some states do not link the financing method and borrowing maturity to a capital asset or its useful life.

As I observed at the outset of this testimony, eliminating the deficit and actually bringing about a budgetary surplus over the next decade constitutes the most important federal contribution to enhancing national investment and long-term growth. Permitting deficit financing of investment might increase federal investment, but the federal deficit could well be larger, thus counteracting the budget balancing goal and reducing the level of private investment in the national economy. Further, in the short run, permitting deficits to finance capital could hamper the federal government's ability to counteract the business cycle through fiscal policy--a responsibility states do not have.

Deficit financing of investment would create another problem for the integrity of any budget process. If investments can be deficit financed while other types of activities cannot, there would be significant incentives to try to categorize the other activities as investment.

Establish Investment Targets

The Budget Enforcement Act of 1990 (BEA) established a set of caps on discretionary spending as part of the budget control process. Investment spending could be considered formally in the budget process by establishing similar aggregate targets for investment within the overall caps. Since we believe that the primary budgetary objective should be to reduce the deficit, a declining

unified budget deficit path should be determined first. Then, within that path, a target for investment spending could be established to shift the spending mix to include more investment. Policymakers could evaluate individual investment programs, an issue I will discuss very shortly, to determine which competing investments should be selected within the overall target.

Setting an investment target would require policymakers to evaluate the current level of investment spending and would encourage a conscious decision about an appropriate overall level of investment. Given the way the budget is now controlled, however, a number of implementation questions would be raised by deciding to increase investment spending. These questions include the following.

-- On what basis can a conscious decision be made on an appropriate level of investment and how can we be assured that only worthwhile projects are funded?

-- Within the current budget enforcement framework, would separate floors (that is, targets), as well as caps be necessary?

-- How would investment and noninvestment activities be allocated to congressional committees?

-- Would trade-offs be allowed between discretionary spending for

investment and mandatory programs that support consumption or only within the discretionary category?

In our view, this approach has the advantage of focusing budget decisionmakers on the overall level of investment supported in the budget without losing sight of the unified budget deficit's impact on the economy. It also has the advantage of building on the current congressional budget process as the framework for making decisions.

CHOOSING FEDERAL INVESTMENT

Regardless of how the budget is structured to display federal investment, it will be important to choose investments wisely. We have developed a framework for selecting federal investment programs that could assist the Congress in making investment decisions.[6]

Ideally, policymakers should have access to measures of relative rates of return from federal investment programs in allocating resources among programs. However, such data are scarce and additional research is needed to develop more and better information on the economic effects of various types of investment proposals. Nevertheless, a few well-considered questions may help

[6]Federal Budget: Choosing Public Investment Programs (GAO/AIMD-93-25, July 23, 1993).

congressional decisionmakers assess the relative worth of competing investments.

Is the Program Designed to Produce Long-Term Economic Growth?

Identifying federal programs that increase private sector labor productivity and economic growth is an important step in devising a federal investment strategy. This is best demonstrated by estimating national economic returns, but calculating those returns is often difficult because of the lack of reliable data. In practice, certain types of public investment programs--infrastructure, human capital, and research and development--have been found to increase productivity. In evaluating an investment program, it is important to ensure that the program increases overall national economic growth and that its primary effect is not just to redistribute economic benefits from one region or sector to another.

Is the Program Worth Implementing?

Not all investment programs are equally valuable. Some programs will contribute more than others to increased productivity and economic growth or other national needs. One must estimate the program's net benefits to the nation's economy and how quickly the benefits and costs accrue. One also needs to define the problem as explicitly as possible to identify the program best suited to deal

with the problem and whether alternatives have been considered. In addition, one must determine whether the problem requires government intervention and at which level--federal, state, or local.

Is the Investment Program Well-designed?

An investment program may effectively address a well-defined problem but still fail to contribute to private sector output and economic growth because of design flaws. One must determine if the program can work as designed and whether the program is properly targeted to the areas or populations where the highest net benefits can be achieved. One must determine also if factors outside the program will hinder its success and whether it is properly coordinated with other federal programs and those of state and local governments.

How Should the Program Be Evaluated After Implementation?

Even if investment programs are worthwhile and well-designed, success is never guaranteed. Priorities and external conditions may change so that even a well-conceived program, over time, may have disappointing outcomes. To improve the federal government's ability to invest wisely in the future, more must be learned about public investments already made. It is therefore important that

all public investment programs include, at the time of their implementation, provisions for evaluating program outcomes.

CONCLUSIONS

Mr. Chairman, we share your concern about investment and long-term economic growth in the United States and the role that budget decisions play in promoting that growth. The most important contributions the federal government can make to a healthy and growing economy are (1) reducing the federal deficit and (2) making wise decisions on investments that will foster economic growth. The current budget structure, with its focus on short-term goals, does not meet these needs.

If we are to increase long-term economic growth, the budget must be structured to focus on long-term decision-making. A federal investment budget component could help the Congress and the President make better informed decisions regarding federal spending on consumption versus investments for the future. Recognizing the importance of the deficit to long-term growth, however, such a component should be established within the context of a unified budget framework seeking to reduce the deficit over an appropriate period. Establishing investment targets in the congressional budget resolution could be a useful and feasible way to implement this concept.

This Subcommittee has selected an excellent issue for public debate. Debate on the bills before you today may begin moving the budget toward a recognition of the contribution of public investment to our economy.

Mr. Chairman, this concludes my remarks. I would be happy to answer any questions that you or Members of the Subcommittee may have at this time.

Mr. CONYERS. Very thoughtful presentation.

There are members of the committee that will be submitting questions to all of you in writing. We will leave the record open for at least 10 days.

All of your prepared statements will be incorporated in their entirety into the record.

Again, my thanks for a very, very important hearing.

[Whereupon, at 12:35 p.m., the subcommittee adjourned, to reconvene subject to the call of the Chair.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Questions For Dr. Robert Eisner
Hearing: National Performance Review --
Capital Budgeting for Investment (11/6/93)

November 22, 1993

1) Unlike businesses, the Federal government has an interest in not only making sound public investment decisions and generating economic returns for itself, but also generating economic returns for those in the private sector. Dr. Jorgenson suggests education should be excluded from a capital budget because it generates returns, admittedly significant returns, for private individuals. Does it make an economic difference if the Federal government is promoting an investment in which the benefit is realized by a private citizen?

2) What new budgetary concepts or definitions would we need to develop or refine to take advantage of a capital budget structure?

3) What sorts of budget accounts should be considered for inclusion in a capital budget?

4) Deficit reduction pressures have constrained the growth of discretionary spending. Under current law, annual spending for discretionary programs will decline by 12.5%, in real value, over the next five years. From an economic perspective, what is the impact of this deficit reduction strategy in terms of our ability to promote economic growth through public investment?

5) Our ability to fund needed national investment is closely linked to the availability of discretionary spending. Yet the category of discretionary spending is precisely the area of spending most constrained by our deficit reduction efforts. By separating out those areas of investment spending and current consumption spending, can we better direct scarce fiscal resources towards those areas where we can generate the greatest economic return?

NORTHWESTERN UNIVERSITY

Robert Eisner
William R. Kenan Professor

Department of Economics
2003 Sheridan Road
Evanston, Illinois 60208-2600
TEL. (708) 491-5394
FAX. (708) 491-7001

HOME TEL: (708) 869-8557, HOME FAX. (708) 869-8559

December 3, 1993

Honorable John Conyers, Chairman
House Government Operations Committee
2157 Rayburn
Washington, DC 20515

Dear Mr. Conyers:

In answer to the questions posed in your communication of November 22, which I have just received:

1) We are not a totalitarian state. The government exists for the people, not the people for the government. We should be concerned with the welfare of the people and the balance sheet of the nation. We should hence construct a balance sheet for the nation and count government investment in education as an addition to the nation's assets. We should indeed similarly count private investment in education as an addition to the nation's assets.

2) and 3) We should begin by applying the concepts of private accounting and have separate current and capital budgets as I indicated in my statement and set forth in tables in the statement. We should include in the current budget only the consumption of capital, not new investment. We should, however, also include investment in intangible capital, at least education and research but possibly also a portion of health expenditures, in the capital budget and add net investment in these items each year to the assets in the balance sheet. Current depreciation or consumption of capital of all of these items should be included in the current accounts.

4) The deficit reduction strategy severely threatens both our ability to promote long-run growth and our ability to achieve full employment. We should be prepared to increase the deficit to finance public investment. This will increase current purchasing power and create jobs now. It will also add to productivity in the future.

5) I would hope that by separating out investment spending we can make clear to the Congress and the public that increases in such investment are not adding to the current deficit, properly measured. We should also have a meaningful guide to public spending so that we can know what is contributing only to current production and consumption and what is contributing to investment which will make us better off in the future.

I hope this is helpful.

Sincerely,

Robert Eisner

C A S
COLLEGE OF ARTS AND SCIENCES

Questions For Dr. David Aschauer
Hearing: National Performance Review --
Capital Budgeting for Investment (11/6/93)

November 22, 1993

1) Unlike businesses, the Federal government has an interest in not only making sound public investment decisions and generating economic returns for itself, but also generating economic returns for those in the private sector. Dr. Jorgenson suggests education should be excluded from a capital budget because it generates returns, admittedly significant returns, for private individuals. Does it make an economic difference if the Federal government is promoting an investment in which the benefit is realized by a private citizen?

2) What new budgetary concepts or definitions would we need to develop or refine to take advantage of a capital budget structure?

3) What sorts of budget accounts should be considered for inclusion in a capital budget?

4) Deficit reduction pressures have constrained the growth of discretionary spending. Under current law, annual spending for discretionary programs will decline by 12.5%, in real value, over the next five years. From an economic perspective, what is the impact of this deficit reduction strategy in terms of our ability to promote economic growth through public investment?

5) Our ability to fund needed national investment is closely linked to the availability of discretionary spending. Yet the category of discretionary spending is precisely the area of spending most constrained by our deficit reduction efforts. By separating out those areas of investment spending and current consumption spending, can we better direct scarce fiscal resources towards those areas where we can generate the greatest economic return?

BATES COLLEGE
LEWISTON, MAINE 04240

DAVID ALAN ASCHAUER
ELMER W. CAMPBELL PROFESSOR
OF ECONOMICS
(207) 786-6099

February 17, 1994

The Honorable John Conyers, Jr.
Chairman
Legislation and National Security Committee
Committee on Government Operations
Congress of the United States
2157 Rayburn House Office Building
Washington, DC 20515-6143

Dear Mr. Conyers:

Thank you for the opportunity to serve as a witness before the Legislation and National Security Subcommittee of the House Government Operations Committee on November 9, 1993.

As I reflect on the testimony given by the witnesses, a fundamental question comes to my mind. Before all else, we must determine the primary purpose of the implementation of a capital budget for the federal government. My thinking leads to three possible purposes, each of which would indicate a need for a different budgetary framework.

Purpose #1: to obtain an accurate financial statement of the assets and liabilities of the federal government. This would entail what we may term a *capital budget*.

If this is the primary purpose, then I feel we should follow rather closely the suggestion of Professor Jorgenson and include only those assets which are owned by the federal government. This would mean the exclusion of human capital and research and development capital from the capital budget since federal expenditures on such items "generates an asset for the private sector, not for the government sector."[1] It would also imply the exclusion of grants to state and local governments, even for tangible capital formation purposes such as highways.

Purpose #2: to obtain an accurate estimate of federal government investment expenditures which, together with private investment spending, would allow an estimate of national investment expenditures. This would entail what we may term

[1]D. Jorgenson, "Capital Budgeting for the Federal Government?" p.5

an *investment budget.*

If this is the fundamental motivation, then we should follow Professor Eisner's framework and include all investment expenditures undertaken by the federal government, on tangible and intangible capital, regardless of the ultimate ownership of the asset. compare this budget framework with the previous capital budget framework. Here, federal expenditures on education would be combined with state and local and private expenditures on education to obtain national investment in this form of human capital. Following Professor Jorgenson's suggestion would involve an understatement of national investment expenditures since private expenditures would be exclusive of the federal "subsidy" to the private sector.

Further, this budgetary framework would include expenditures on "productive" capital such as highways as well as "unproductive" capital such as military hardware. Separate classification of these two types of expenditures could, however, be made under the investment budget.

Purpose #3: to obtain an accurate estimate of the range of government expenditures which raise private sector productivity and stimulate long term economic growth. This would entail what we might call a *productivity budget.*

At first blush, it would appear that we could follow the framework set out by Paul Posner and include "spending on activities that enhance long-term productivity, regardless of whether they are tangible or intangible..." and exclude "spending on physical assets, such as federal office buildings and military weapon systems..." since the latter "do not directly increase the private sector's longer term productive capacity."[2]

I am sympathetic to this approach (indeed, it accurately reflects my original motivation for researching the linkage between public capital and private sector productivity). But as I point out in my testimony, it is inadequate to look only at public investment when one is concerned with the impact of public expenditures on productivity and long term growth. Public consumption spending can just as easily affect the long run (steady state) level of income and, in doing so, affect the growth rate of the economy in the short and intermediate term.[3] This would not be a particularly important point if the short and intermediate term were rather brief; but empirical estimates indicate a rather lengthy transition from one to another steady state (perhaps 30 years). What I am saying is that in the context of the most widely used model of economic growth the dichotomy between public consumption and public investment is truly a false dichotomy. Yet the dichotomy between productive and unproductive public expenditure is decidedly not false. We need to be certain that

---

[2]P. Posner, "Investment Budgeting for the Federal Government," pp. 7-8.

[3]D. Aschauer, "Statement on Capital Budgeting," p. 3.

in our federal budgeting process productive government spending--of a current or a capital nature--be adequately funded to maximize our long term economic welfare.

This last framework is also useful in that it allows an integration of productive government spending and the impact of taxation on the economy. This lets us bring in Professor Jorgenson's ideas in the latter portion of his written testimony. Specifically, we could adopt the following criterion: government programs may be included in the productivity budget only if their net of tax benefit exceeds their opportunity cost. Under this criterion, the optimal level of government spending in a particular area would occur at the point at which the productive benefit of the spending program would be exactly matched by the distorting effect of the means of taxation. In particular, a typical program would be funded at a lower level if we relied more heavily on an a capital income tax than on some form of a consumption tax.

I also state in my written testimony that I am not advocating a productivity budget for the federal government. While such a productivity budget makes good sense if our primary interest is to ensure adequate long term growth, it would be somewhat difficult to implement. However, I am now somewhat more sympathetic to my own idea, since it would seem to offer no greater practical difficulties than would the adoption of the GAO investment budget concept.

I hope these reflections are informative to you. I look forward to further interaction with the Subcommittee on this important issue.

Sincerely,

David Alan Aschauer

Questions For Dr. Letitia Chambers
Hearing: National Performance Review --
Capital Budgeting for Investment (11/6/93)

November 22, 1993

1) Unlike businesses, the Federal government has an interest in not only making sound public investment decisions and generating economic returns for itself, but also generating economic returns for those in the private sector. Dr. Jorgenson suggests education should be excluded from a capital budget because it generates returns, admittedly significant returns, for private individuals. Does it make an economic difference if the Federal government is promoting an investment in which the benefit is realized by a private citizen?

2) What new budgetary concepts or definitions would we need to develop or refine to take advantage of a capital budget structure?

3) Under current law, annual spending for discretionary programs will decline by 12.5%, in real value, over the next five years. From an economic perspective, what is the impact of this deficit reduction strategy in terms of our ability to promote economic growth through public investment?

4) The declining share of funds available for discretionary spending corresponds with an increasing proportion of entitlement and mandatory spending. The Federal government pays about 31% of the nation's health care bills. Can health care reform offer some help her by decreasing the pressure on the discretionary spending category?

5) The Federal government spends about $400 billion each year for various tax credits, deductions and exemptions. Spending for these "tax expenditures" is not generally considered a budget program because the money is never entered onto the Federal budget. Should Congress think of these as spending programs, similar to a discretionary or entitlement program? How can Congress better budget these sorts of tax expenditures?

6) Many analysts are troubled by the current consolidated budget, which fails to recognize full spending for various Federal subsidies, such as timber sales, animal grazing or mineral extraction on public lands. How can the budget process be improved to reflect the cost of Federal subsidies? Is increased disclosure, such as through H.R. 742, the FIRESALE Disclosure legislation introduced by Representative Synar, an important first step?

January 26, 1994

Dr. Chambers Response to Questions Submitted for the Record

Answer to Question 1:

Dr. Jorgensen suggests that education should be excluded from the capital budget because it generates returns for private individuals. Whether or not private individuals are benefitted is not an appropriate criteria in my opinion by which to determine budgetary status. Government activities should and do generate benefits for private individuals because governments do not exist to benefit themselves; they only exist for the benefit for their citizens. Much of what is generally considered public investment would have to be reclassified if the litmus test became: "Does the activity provide a return to individuals?" For example, most observers consider the most successful government infrastructure investment since World War II the Interstate Highway System. The benefits from this system accrued primarily to individuals and the business sector.

Answer to Question 2:

To immediately institute a capital budget, while retaining the cash basis for accounting in the Federal government, no new concepts or definitions would be required. To move to an accrual system with depreciation schedules in the capital budget would involve significant work on budget concepts. In view of the fact that the General Accounting Office, the Department of the Treasury, and the Office of Management and Budget have been working on accrual accounting and have reached no consensus on whether and how to move to accrual accounting, I do not believe that we should wait on instituting a capital budget until that work is complete. I recommend instituting a capital budget but retaining cash accounting.

Answer to Question 3:

The fact that discretionary spending will be under considerable pressure because of the cap is an argument for a tripartite budget structure, including a separate capital investment budget, as I recommended in my testimony before the Subcommittee on Legislation and National Security. When government consumption activities compete with government investment activities, consumption spending often wins out because the benefits from investment are long-term, while the benefits from consumption spending are more immediately apparent. That is why consumption and investment should be considered separately. This could require the Congress to consider separate discretionary caps -- one for investment and one for consumption.

Answer to Question 4:

I do not believe that we should look to health care reform as the panacea for our budgetary problems. The Clinton Administration considers universal coverage a non-negotiable element of health care reform. I agree with that principle. Once one accepts the principle of universal coverage, it becomes very difficult to achieve major deficit reduction over the next five years on the basis of provisions adopted in health care reform. In addition, most of the health care spending by the Federal government is for the mandatory programs, Medicare and Medicaid in particular. The Clinton administration proposes some decreases in these programs to help finance its reform proposal. I believe it is unrealistic to expect deficit reduction over the near term from health reform.

Answer to Question 5:

As discussed in my prepared statement, tax expenditures are a significant budget activity. I consider them to be a form of mandatory spending since tax expenditures typically remain in effect unless Congress changes the law. I think that tax expenditures should be specifically included in the Federal budget.

Answer to Question 6:

The tripartite budget structure that I outlined in my testimony represents a way to move to a better presentation of the cost of Federal subsidies. I would also support increased disclosure as recommended by Representative Synar in H.R. 742.

GAO

United States
General Accounting Office
Washington, D.C. 20548

Accounting and Information
Management Division

RECEIVED
JAN 25 1994
HOUSE COMMITTEE ON
GOVERNMENT OPERATIONS

December 17, 1993

The Honorable John Conyers, Jr.
Chairman, Committee on
Government Operations
House of Representatives

Dear Mr. Chairman:

I welcomed the opportunity to testify on investment budgeting before the Committee on Government Operations, Subcommittee on Legislation and National Security. As you noted, alternative budget presentations may offer the opportunity to more effectively address the potentially conflicting goals of deficit reduction and increased federal investment.

I also appreciated the chance to respond to your additional questions in writing for the hearing record. Enclosed are my answers to the questions you sent in your letter dated November 22, 1993.

I look forward to a continuing dialogue on this important subject.

Sincerely yours,

Paul L. Posner
Director, Budget Issues

Enclosure

RESPONSES TO QUESTIONS FOR PAUL POSNER
HEARING: NATIONAL PERFORMANCE REVIEW
CAPITAL BUDGETING FOR INVESTMENT (11/9/93)

Question 1: Under current law, annual spending for discretionary programs will decline in real value by 12.5% over the next five years, further decreasing the share of Federal spending directed to discretionary programs. This declining share of discretionary funds may decrease Federal ability to make necessary investments. If we adopt the GAO recommendation of an "investment target," Congress may increase the visibility of investment spending. However, how does a change in budgetary display affect our ability to increase the magnitude of our public investments?

Answer: A budget display merely highlights what is proposed to be spent on investment and other discretionary programs. To actually increase the magnitude of public investment, the Congress and the Administration would need to agree on the appropriate overall level of investment spending. Establishing targets in law for this agreed upon investment level, similar to BEA's discretionary spending limits, could help assure that the targets are met.

Question 2: In your testimony, you proceed through some criteria to evaluate sound investments. What budget functions or categories would you look to in developing an investment budget?

Answer: We would use OMB's character class[1] data as the starting point for identifying investment spending directly intended to promote the private sector's economic growth. Our recent report on investment budgeting[2] presents two examples of spending that could be included in this definition of investment. The first example includes direct federal and grant outlays for (1) R&D construction and equipment, (2) R&D, except for Defense applied research and weapons activities development research, which we believe is unlikely to be applicable to civilian use, and (3) education and training. It also includes grants to state and local governments for infrastructure, such as highways and acquisition of equipment, and a small selection of outlays for direct federal construction and acquisition of equipment, such as flood prevention and control, construction of power generating facilities, and acquisition of air traffic control equipment.

The second example of spending that could be considered to be investment includes all spending in the first example as well as spending on childhood immunization programs and WIC. Some experts

---

[1]Character classification codes are used by OMB to report budget outlays for investment (as defined by OMB) separately from noninvestment.

[2]Budget Issues: Incorporating an Investment Component in the Federal Budget (GAO/AIMD-94-40, November 1993).

BOSTON PUBLIC LIBRARY
3 9999 05982 406 8

on a panel we convened to discuss investment issues believed that such spending was also likely to contribute to the nation's long-term productivity.

Question 3: The declining share of funds available for discretionary spending corresponds with an increasing proportion of entitlement and mandatory spending. The Federal government pays 31% of the nation's health care bill. Can health care reform offer some relief by decreasing the pressure on the discretionary spending?

Answer: The current pressure on discretionary spending is embodied in the discretionary spending limits contained in the BEA, as amended. Most federal health spending is in the mandatory, or "PAYGO," portion of the budget so does not directly affect discretionary spending limits. If health care reform results in an overall decrease in federal net outlays, the Congress and the Administration might choose to re-negotiate the discretionary spending limits in light of an improved deficit outlook. However, since health care reform has not yet been enacted, it would be premature to speculate on whether it will be able to reduce the pressure on discretionary spending.

Question 4: Your testimony refers to an earlier GAO report that identified 37 states adopt a form of capital budget. What sort of spending programs do states place in their capital budget?

Answer: States define capital outlays as expenditures which result in the acquisition of or addition to major fixed assets such as land, buildings, and equipment. The following descriptions are representative of the types of spending programs states include in their capital budgets.

-- California's 1993-1994 capital outlay program included money to renovate the state's existing prison and youth detention facilities, improve and replace old fire stations, acquire and develop state park lands, and renovate, modernize, and build new schools.

-- Pennsylvania's 1993-1994 capital budget grouped projects into the categories of public improvement, transportation assistance, redevelopment assistance, site development, flood control, and highway projects.

-- New Jersey's 1992-1993 budget defined capital outlays as the acquisition of land, construction of new buildings, and any project whose estimated cost was $50,000 or more regardless of the construction involved.

-- Washington's 1991-1993 budget proposal included capital spending for constructing schools, upgrading and repairing facilities at two-year and four-year institutions, investing in low- and

moderate-income housing assistance efforts, and preserving natural resource lands.

Question 5: States have very different responsibilities from the Federal government and, generally, have little responsibility for programs like science research or job training, where they administer Federal funds, because the benefits are difficult to maintain with the state. By contrast, the Federal government has an obligation to promote national goals. Are there limits to the lessons we can draw from the state systems?

Answer: First, state and federal responsibilities differ and this has important implications for capital budgeting. States focus their capital budgets primarily on physical capital since the benefits of job training and R&D are not easily captured within a state. On the other hand, the federal government would want to include these types of programs in any investment budget since these are federal responsibilities. Second, states do not budget on a unified basis but rather on a fund basis. Their capital funds are generally not subject to balanced budget requirements. While perhaps appropriate for the state level, the federal government has a unique responsibility for macroeconomic management. Since the entire cash budget deficit or surplus has an important bearing on the economy, budget control at the federal level should continue to be defined in unified budget terms.

Question 6: The Federal government spends about $400 billion each year for various tax credits, deductions and exemptions. Spending for these "tax expenditures" is not generally considered a budget program because the money is never entered onto the Federal budget. Should Congress think of these as spending programs, similar to a discretionary or entitlement program? How can Congress better budget these sorts of tax expenditures?

Answer: At a time when the federal government faces hard choices to reduce the deficit and allocate available resources, no federal expenditure, whether it involves outlays or losses to the treasury, should escape careful examination and control. Tax expenditures--like other spending programs--exist to achieve particular federal objectives. However, tax expenditures--unlike most spending programs--are rarely evaluated against their own objectives or related spending programs; and, they remain largely beyond the reach of budgetary controls. Unlike appropriated programs, they are not considered part of the annual budget process, and most are not subject to periodic reauthorization. As a result, policymakers have little opportunity to make comparisons or tradeoffs between these subsidies and related spending programs. Large and growing losses from tax expenditures and questions about their value to the nation strengthen the case for enhanced program examination and budgetary control. Past GAO and CBO reports have questioned the equity and efficiency of tax expenditure programs and called for specific improvements to improve their design and targeting.

Moreover, despite tax base-broadening and budget reforms of the 1980s, tax expenditures will exceed $400 billion in fiscal year 1994.

Integrating tax expenditures into budgetary processes would put these subsidies on a more equal footing with outlays and could contribute to a more balanced approach to deficit reduction. GAO is currently examining options for further budgetary integration at the request of Congressman Coyne. It is important to recognize in this regard that subjecting tax expenditures to the types of budgetary limitations and enforcement devices that currently apply to most outlay programs would broaden the powers of the Congress and the Budget Committees vis-a-vis the tax committees by inviting others into the decision process. Disagreements about what constitutes a tax expenditure, measurement problems, and technical difficulties also could confound the application of budgetary control mechanisms. These are clearly significant issues which we are currently evaluating for our upcoming report to Congressman Coyne.

Question 7: Many analysts are troubled by the current consolidated budget, which fails to recognize full spending for various Federal subsidies, such as timber sales, animal grazing or mineral extraction on public lands. How can the budget process be improved to reflect the cost of Federal subsidies? Is increased disclosure, such as through H.R. 742, the FIRESALE Disclosure legislation introduced by Representative Synar, an important first step?

Answer: We were strong advocates of credit reform, which changed the budget process for credit programs by requiring that their subsidy costs be appropriated up front, before the credit programs were undertaken. Applying a similar concept to subsidies provided by timber sales, animal grazing or mineral extraction on public lands might be possible, but would need to be studied. Such programs, which are not unlike tax expenditures, represent revenue foregone by the government, not additional costs. Increased disclosure of these subsidies would be an important first step toward obtaining an understanding of their magnitude and toward focusing attention on them.

ISBN 0-16-045818-8

90000

9 780160 458187